

Unit 1

AN OVERVIEW

Learning Objectives:

- To define international business and describe how it differs from domestic business.
- To explain why companies engage in international business and why its growth has accelerated.
- To introduce different modes a company can use to accomplish its global objectives.
- To illustrate the role social science disciplines play in understanding the environment of international business.
- To provide an overview of the primary patterns for companies' international expansion.
- To describe the major countervailing forces that affect international business.

Lesson Overview:

The first part of the chapter is designed to give a brief overview of international business in terms of why companies get involved, why there has been a recent growth in international business, the major modes of international business activities, the relationship to other disciplines, and the need to adjust operations to different operating environments. The second part of the chapter introduces features that will be covered in other chapters as well. These include the internationalization process, countervailing forces, ethical dilemmas, and looking to the future.

INTRODUCTION TO THE FIELD OF INTERNATIONAL BUSINESS

International business is all commercial transactions (private and governmental) between two countries.

A. Why Companies Engage in International Business

1. **Expand Sales.** Going international allows companies to increase the size of the market to which they offer their products.
2. **Acquire Resources.** Foreign capital, technology, labor, components all can help a firm become more competitive.
3. **Diversify Sources of Sales and Supplies.** By operating in multiple countries, firms help protect themselves from economic downturns in any single country. In the same way, having suppliers in multiple countries helps protect the firm from shortages due to economic, social, or political disruptions in any single country.
4. **Minimize Competitive Risk.** Companies expand internationally to competitors' home markets in order to maintain a competitive balance across markets.

B. Reasons for Recent International Business Growth—From Carrier Pigeons to the Internet.

1. **Expansion of Technology.** Air travel, the internet, e-mail, e-commerce, direct dial international phone calls, fax, and other technologies have brought down the cost and increased the efficiency of doing business internationally.
2. **Liberalization of Cross-Border Movements.** The World Trade Organization (WTO, discussed in Chapter 6) and other international trade agreements have reduced barriers to the movement of goods and services across national boundaries.
3. **Development of Supporting Services.** International banking, international document delivery, and other services have tremendously simplified the conduct of international business.
4. **Increase in Global Competition.** It is becoming increasingly important that firms have international operations in order to be able to shift production across countries and take advantage of new production location and marketing opportunities to stay ahead of other international competitors.
5. **Exports are goods and services** produced in one country and then sent to another country. Imports are goods and services produced in one country and then brought in by another country. Information about exports and imports helps us to explain the impact of international business on the economy.
6. **Foreign direct investment (FDI)** is equity funds invested in other nations. Industrialized countries have invested large amounts of money in other industrialized nations and smaller amounts in less developed countries (LDCs), such as those in Eastern Europe, or in newly industrialized countries (NICs), such as Hong Kong, South Korea, and Singapore. Most of the world's FDI is in the US, the European Union (EU), and Japan. As nations have become more affluent, they have pursued FDI in geographic areas that have economic growth potential. The Japanese, for example, have been investing heavily in the EU in recent years.

7. **Over 50 per cent** of world trade and over 80 per cent of foreign direct investment is conducted by three regional economic hubs: the US, the EU and Japan. Collectively, these areas are referred to as the “triad”. The triad is a group of three major trading and investment blocs in the international arena.

MODES OF INTERNATIONAL BUSINESS**A. Merchandise Exports and Imports:**

Merchandise exports are tangible products (goods) manufactured in one country and sent out of that country to another one. Merchandise imports are tangible products (goods) brought in from another country.

B. Service Exports and Imports:

Service exports and imports are international earnings that do not come from a tangible product which physically crosses a border. The company receiving payment is making a service export. The company paying is making a service import. Exports are goods and services produced in one country and then sent to another country. Imports are goods and services produced in one country and then brought in by another country. Information about exports and imports helps us to explain the impact of international business on the economy.

1. Tourism and Transportation. When an American flies to Germany on Lufthansa (a German airline) and spends a few days in a German hotel, the payments made to Lufthansa and the hotel are service exports for Germany and service imports for the United States.
2. Performance of Services. When an American engineering firm receives a payment for designing a plant in France, it is a service export for the United States and a service import for France.
3. Use of Assets. International licensing agreements and franchising allow foreign entities to use another firm's trademarks, patents, or technology. Payments for the right to use these assets are a service export for the country receiving those payments and a service import for the country making the payments.

C. Investments:

Foreign investment means ownership of foreign property is exchanged for a financial return (e.g., interest and dividends).

Direct Investment:

1. Foreign direct investment (FDI) occurs when an investor gains a controlling interest in a foreign company. That controlling interest can be 100% or much less. (See "Going Global" additional Exercise 1.3 at end of chapter.) When discussing foreign direct investment, it is important to distinguish between the flow of FDI and the stock of FDI. The flow of FDI refers to the amount of FDI undertaken over a given time period (normally one year). The stock of FDI refers to the total accumulated value of foreign owned assets at a given point in time.
2. Figure 6.1 illustrates the great increase in the flows of FDI between 1992-2001. The significant growth in FDI has both to do with the political economy of trade as outlined in the previous chapter and the political and economic changes that have been taking place in developing countries.

3. The opening case on Starbucks helps illustrate one very important trend in FDI - the globalization of the world economy is causing firms to invest worldwide in order to assure their presence in every region of the world.
4. Another important trend is has been the rise of inflows into the US. The stock of foreign FDI in the US increased more rapidly than US FDI abroad.
5. The rapid increase in FDI growth into the US may be due to the attractiveness of the US market, the falling value of the dollar, and a belief by some foreign corporations that they could manage US assets and workers more efficiently than their American managers could.
6. It is difficult to say whether the increase in the FDI into the US is good for the country or not. To the extent that foreigners are making more productive use of US assets and workers, it is probably good for the country.
7. Figures 6.2, 6.3, 6.4 and 6.5 provide some insight into the countries that have been the major recipients and sources of foreign direct investment in recent years.
8. The management focuses box details the techniques of Mexican cement manufacturer Cemex for its aggressive international expansion of cement manufacturing. Because cement is a product that is not easily exported due to its low ratio of value to weight, Cemex sought international expansion by acquisition.

Portfolio Investment:

Portfolio investment is a non-controlling investment in a foreign company. It is usually a purchase of stock in a foreign company or loan to (bond purchase) a foreign firm.

International Companies and Terms to Describe Them:

The term “collaborative arrangements” between international companies comprises joint ventures, licensing, and manufacturing contracts. “Strategic alliances” are collaborative arrangements that are of critical importance to the competitive viability of one or more of the collaborating firms. Multinational enterprise (MNE), multinational company (MNC), transnational company (TNC) are other terms used to describe organizations operating in multiple countries.

A “global company” tends to integrate its international operations in order to efficiently produce a globally standardized product. A “multidomestic company” tends to be locally responsive and tailors its products to each national market where it operates.

MNC(Multinational Enterprises):

1. MNEs have a number of characteristics, including: (a) responsiveness to environmental forces such as competitors, customers, suppliers, financial institutions, and government; (b) drawing on a common pool of resources, including assets, patents, trademarks, information, and human resources; and (c) affiliates that are linked by a common strategic vision.
2. Under the premise that foreign markets are risky, companies expand their operations abroad incrementally and cautiously. Setting up a wholly-owned subsidiary is usually the last stage of doing business abroad. A typical internationalization process for a firm producing a standardized product

might begin with a licensing agreement: a contractual arrangement in which one firm provides access to some of its patents, trademarks, or technology to another firm in exchange for a fee or royalty. Apart from a licensing agreement, a firm might export via an agent or distributor. This might be followed by the direct hiring of a domestic representative or the establishment of a foreign sales subsidiary. The next step might be the establishment of local packaging and/or assembly operations. This is typically followed by foreign direct investment.

3. Firms become multinationals for a number of reasons. Some of these include: (a) a desire to protect themselves from the risks and uncertainties of the domestic business cycle; (b) a growing world market for their goods or services; (c) a response to increased foreign competition; (d) a desire to reduce costs; (e) a desire to overcome tariff barriers; and (f) a desire to take advantage of technological expertise by manufacturing goods directly rather than allowing others to do it under a license agreement.
4. Multinational enterprises are different from companies that confine their activities to the domestic market. MNEs make decisions based primarily on what is best for the company, even if this means transferring funds or jobs to other countries.

Multinationals in action:

1. Most MNEs are not giant corporations, but the giants are almost all MNEs. Some of the exceptions are major utilities, banks, and retailers that restrict their operations to the home country.
2. MNEs range from extremely large to fairly small in terms of both sales and employment, and they can be found in a variety of different industries.
3. The strategic management process involves four major functions: strategy formulation, strategy implementation, evaluation, and the control of operations.
4. Strategic planning typically begins with a review of the company's basic mission. This is determined by answering the questions: What is the firm's business? What is its reason for existence? By answering these questions, the company reaffirms the direction in which it wants to go. In recent years many MNEs have revised their strategic plan because they realized that they had drifted too far away from their basic mission.
5. After determining its mission, the MNE will evaluate the external and internal environment. The goal of external environmental analysis is to identify opportunities and threats that will need to be addressed. The purpose of internal environmental analysis is to evaluate the company's financial and personnel strengths and weaknesses.
6. Internal and external analysis helps the MNE identify both long-range goals (typically two to five years) and short-range goals (less than two years). The plan is then broken down into major parts, and each affiliate and department will be assigned goals and responsibilities. This begins the implementation process. Progress is then periodically evaluated and changes are made in the plan.

7. There are many ways in which MNEs use the strategic management process. Citibank's expansion to China has historically been influenced and restricted by the government's policies. Zara has created a lightning-speed production and distribution system that is highly responsive to changing demand. Nissan is looking into ways of evaluating and controlling its operations.

External Influences on International Business:

A. Understanding a Company's Physical and Societal Environments:

International business is affected by politics, culture, currency value fluctuations, transportation costs, and other factors that domestic businesses face only in a limited way. The international manager must therefore have a deeper understanding of political science, anthropology, sociology, psychology, geography, and economics.

B. The Competitive Environment:

The "competitive environment" varies by industry, company, and country. Some firm compete based on the price of their products; others compete based on different product features. These different competitive strategies lead to different modes of competition between firms. Companies must understand their industries and competitors as they develop and implement their international business strategy.

Evolution of Strategy in the Internationalization Process:

Patterns of Expansion:

Firms tend to follow a pattern of increasing international involvement. Companies usually are initially reluctant to undertake international activity, but that reluctance diminishes as they become more experienced.

AN OVERVIEW

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Passive to Active Expansion:

Initially, firms simply respond to international demand for their product. Later, they start planning how to best expand internationally.

External to Internal Handling of Operations:

Initially, firms use freight forwarders, customs brokers, and other external companies to help handle the details of international business. Later, once the firm has learned more about international operations, it will often perform these functions itself.

Deepening Mode of Commitment:

Firms usually begin international activities by either importing or exporting. These activities require no overseas investment and minimal commitment to international opportunities. As the rewards of international business become more apparent and foreign markets become more familiar, the firm may expand its international commitment and begin even producing some of its products abroad.

Geographic Diversification:

At first, companies will do business only in one or two other countries (usually countries nearby and with cultural similarities to the company's home country). As time goes by and the company learns more, it will tend to expand its operations into more distant and varied location

Leapfrogging of Expansion:

Despite the common patterns of expansion discussed above, technological and political changes have made it possible for firms to bypass the common expansion patterns. The World Wide Web, for example, allows firms to seek out global markets for their products with ease.

Countervailing Forces:

A. Globally Standardized versus Nationally Responsive Practices

On the one hand, offering a globally standardized product enables the firm to engage in mass production and mass marketing which can generate economies of scale giving the firm a big cost advantage over competitors. On the other hand, being nationally responsive and tailoring your product to consumers in each country where you operate can make your product more desirable than something mass-produced for a global market. (See "Going Global" Exercise 1.2 at end of chapter.)

B. Country versus Company Competitiveness

Sometimes the interests of a firm coincide with the interests of the firm's home country (e.g., "What's good for General Motors is good for the U.S."). However, sometimes what is good for the firm may be bad for the firm's home country (e.g., shipping jobs from the home country to cheaper foreign locations).

Businesses need to understand the complex ways in which their operations affect their home and host countries in order to make the most prudent economic and political decisions.

C. Sovereign versus Cross-National Relationships

Countries may collaborate with each other or compete. Collaboration often involves a country giving up some of its sovereignty (for example, making treaties may limit a country's ability to act autonomously). Though countries normally prefer to maintain their sovereignty, they will often collaborate to gain reciprocal advantages (e.g., through trade agreements), to attack problems that a single country acting alone cannot solve (e.g., environmental agreements), or to deal with areas of concern that lie outside the territory of all countries (e.g., Antarctic exploration).

Unit 2

GLOBALIZATION**Learning Objectives:**

1. Introduce the student to the contemporary issues in international business that illustrates the unique challenges of international business.
2. Point out the macro-economic and political changes that have taken place in the last 30 years, and suggest the implications of these changes for international business.
3. Illustrate the importance of information technology and technological changes in driving the globalization of products and markets.
4. Explore the changing nature of firms that do business outside their national borders, many small firms in remote locations can now market their products and services world wide through the internet.
5. Highlight some of the concerns raised by critics of globalization, and the adverse effects globalization can have on some firms and individuals.
6. Explore the challenges that globalization holds for managers within an international business.

Lesson Overview

THE GLOBAL GROCER

INTRODUCTION

WHAT IS GLOBALIZATION?

The Globalization of Markets

The Globalization of Production

DRIVERS OF GLOBALIZATION

Declining Trade and Investment Barriers

The Role of Technological Change

THE CHANGING DEMOGRAPHICS OF THE GLOBAL ECONOMY

The Changing World Output and World Trade Picture

The Changing Foreign Direct Investment Picture

The Changing Nature of the Multinational Enterprise

The Changing World Order

The Global Economy of the 21st Century

THE GLOBALIZATION DEBATE: PROSPERITY OR IMPOVERISHMENT?

Anti-globalization Protests,

Globalization, Jobs, and Incomes

Globalization, Labor Policies, and the Environment

Globalization and National Sovereignty

Globalization and the World's Poor

GLOBALIZATION

What is globalization?

1. There is a movement towards a globalization of markets, as the tastes and preferences of consumers in different nations are beginning to converge upon some global norm. The global acceptance of Coca-Cola, Levi's jeans, Sony Walkmans, and McDonald's hamburgers are all examples. Yet there are still significant differences - Germany still leads in per capita beer consumption, with a local pub on almost every corner and in some cities, women selling beer out of their front windows to passers by on the street. The French lead in wine consumption, and the consumption of wine is a natural part of life anywhere in France. Italians lead in pasta eaten, and these differences are unlikely to be eliminated any time soon. Hence, often there is still a need for marketing strategies and product features to be customized to local conditions.
2. There is a movement towards a globalization of production, as firms disperse parts of their production processes to different locations around the globe to take advantage of national differences in the cost and quality of factors of production. The examples of Boeing and Swan Optical illustrate how production is dispersed. While part of the rationale is based on costs and finding the best suppliers in the world, there are also other factors. In Boeing's case, if it wishes to sell airliners to countries like China, these countries often demand that domestic firms be contracted to supply portions of the plane - otherwise they will find another supplier (Airbus) who is willing to support local industry.

Drivers of globalization:

1. Two key factors seem to underlie the trend towards the increasing globalization of markets and production: 1) the decline of barriers to trade and investment and 2) technological change.
2. After WWII, the industrialized countries of the West started a process of removing barriers to the free flow of goods, services, and capital between nations. Under GATT, over 140 nations negotiated even further decreases in tariffs and made significant progress on a number of non-tariff issues (e.g. intellectual property, trade in services). With the establishment of the WTO, a mechanism now exists for dispute resolution and the enforcement of trade laws.
3. This removal of barriers to trade has taken place in conjunction with increased trade, world output, and foreign direct investment.
4. The growth of foreign direct investment is a direct result of nations liberalizing their regulations to allow foreign firms to invest in facilities and acquire local companies. With their investments, these foreign firms often also bring expertise and global connections that allow local operations to have a much broader reach than would have been possible for a purely domestic company.
5. While lowering trade barriers has made the globalization of markets and production a possibility, technological changes have made it a reality.

GLOBALIZATION

Technology Improvement:

Improved information processing and communication allow firms to have better information about distant markets and coordinate activities worldwide. The explosive growth of the World Wide Web and the Internet provide a means to rapid communication of information and the ability of firms and individuals to find out about what is going on worldwide for a fraction of the cost and hassle as was required only a couple of years ago.

Improvements in transportation technology, including jet transport, temperature controlled containerized shipping, and coordinated ship-rail-truck systems have made firms better able to respond to international customer demands.

As a consequence of these trends, a manager in today's firm operates in an environment that offers more opportunities, but is also more complex and competitive than that faced a generation ago. People now work with individuals and companies from many countries, and while communications technology, with the universality of English as the language of business, has decreased the absolute level of cultural difficulties individuals face, the frequency with which they face inter-cultural and international challenges has increased. Exports are goods and services produced in one country and then sent to another country. Imports are goods and services produced in one country and then brought in by another country. Information about exports and imports helps us to explain the impact of international business on the economy.

1. Foreign direct investment (FDI) is equity funds invested in other nations. Industrialized countries have invested large amounts of money in other industrialized nations and smaller amounts in less developed countries (LDCs), such as those in Eastern Europe, or in newly industrialized countries (NICs), such as Hong Kong, South Korea, and Singapore. Most of the world's FDI is in the US, the European Union (EU), and Japan. As nations have become more affluent, they have pursued FDI in geographic areas that have economic growth potential. The Japanese, for example, have been investing heavily in the EU in recent years.
2. Over 50 per cent of world trade and over 80 per cent of foreign direct investment is conducted by three regional economic hubs: the US, the EU and Japan. Collectively, these areas are referred to as the "triad". The triad is a group of three major trading and investment blocs in the international arena.

Today's global environment

Over the last few decades an increasing number of countries have embraced trade and investment liberalization. Notwithstanding, triad countries have often had disagreements about implementation. A number of mechanisms to solve disputes among countries have evolved; the main one is the World Trade Organization (WTO), established in 1995. Today, the WTO is the umbrella organization that governs the international trading system. When member countries have a dispute they turn to the WTO's dispute-settlement mechanism to help resolve it. For example, the US and the EU have brought cases against each

other in such matters as banana imports, beef hormones, steel, and foreign sales corporations. The WTO can enforce its decisions. Countries that refuse to comply can find themselves suffering severe consequences in the form of trade retaliation.

Technology is having a major impact on the way multinational enterprises MNEs do business. Over the last few years, communication technology has allowed all business to use computers, mobile phones and to rely on the World Wide Web to access and send information. New technological developments have also been applied to the production of goods and services. Companies can now implement quality programs and improve manufacturing flexibility, among other things.

International business is not limited to giant multinational enterprises. Many small and medium-sized businesses are also involved in this arena. These include service industries, which currently employ about 70 per cent of all workers in the US and Canada.

Globalization and strategic management:

- A.** A common misconception about international business is that MNEs have far-flung operations and earn most of their revenues overseas. In fact, most MNEs earn the bulk of their revenues either within their home country or by selling in nearby locales. Of the largest 500 MNEs, 198 are headquartered in North America, 156 are in the EU and 125 are in Japan/Asia. These firms are not spread around the world but are clustered in the triad and engage in triad/regional competition. MNEs do not develop homogeneous products for the world market but must adapt their product to local markets. For example, there is no global car but regional-based auto factories that are supported by regional/local suppliers and design cars to meet the preferences of local/regional customers.
- B.** There are three things a nation must do to gain and hold strong international trading and investment positions: (a) maintain economic competitiveness; (b) influence trade regulations so that other countries open their doors for its goods and services; and (c) develop a global orientation that allows firms to operate as MNEs, not just as local firms doing business overseas.
- C.** Research shows that the best way for companies to achieve competitive advantage is through innovation. Often this is accomplished through ongoing improvement of goods or services. A second way is by making existing products obsolete, by developing new and better products that replace old ones.
- D.** Why can some firms innovate consistently while others cannot? According to Porter, the answer rests in four broad attributes that individually and interactively determine national competitive advantage: factor conditions, demand conditions, related and supporting industries, and firm strategy, structure and rivalry.
- E.** Factor conditions include land, labor, and capital that are used to develop international market niches and tap world markets. Demand conditions require a sophisticated local demand that helps businesses fashion and shape the goods and services that will later be offered on the world market. Related and supporting industries help MNEs remain abreast of low-cost inputs and knowledge

regarding what is happening in their industry. Firm strategy, structure, and rivalry help organizations create, organize, and manage their operations in the face of competitiveness.

- F.** Each of the four determinants in Porter's model often depends on the others. For example, if a country has sophisticated buyers that can provide a company with feedback regarding how to modify or improve its product (demand conditions), this information will not be useful if the firm lacks personnel with the skills to carry out these functions (factor conditions). Similarly, if suppliers can provide the company with low-cost inputs and fresh ideas for innovation (related and supporting industries), but the firm clearly and easily dominates the industry (firm strategy, structure, and rivalry) and does not feel a need to upgrade the quality of its products and services, it will eventually lose this competitive advantage.
- G.** Porter notes that government and chance influence the four determinants in Figure 1.1. Government policies, for example, can have serious consequences for international trade, since government intervention for the purpose of protecting home industries usually results in less competitive national companies. There is often strong domestic pressure to provide such protection. Yet research shows that a government's major role in international business may well be that of world trade negotiator.
- H.** Many companies do business in other countries, but they have not developed the needed international perspective. This requires attention in three areas: experience, focus, and attitude. One way to create an international perspective is to hire individuals with international experience. A second way is to emphasize the importance of international activities. A third way is to change the attitudes that many managers have toward their work.

The changing demographics of the global

The U.S. share of world output has declined dramatically in the past 30 years, and a much more balanced picture is now developing among industrialized countries. Looking ahead into the next century, the share of world output of what are now referred to as "developing countries" is expected to greatly surpass that of the current "industrialized countries."

GLOBALIZATION

The changing demographics of the global economy:

1. The U.S. share of world output has declined dramatically in the past 30 years (See Table 1.2), and a much more balanced picture is now developing among industrialized countries. Looking ahead into the next century, the share of world output of what are now referred to as “developing countries” is expected to greatly surpass that of the current “industrialized countries.”
2. The source and destinations of FDI has also dramatically changed over recent years, with the US and industrialized countries becoming less important (although still dominant) as developing countries are becoming increasingly considered as an attractive and stable location for investment (See Figures 1.3 and 1.4).
3. A number of large multinationals are now non-U.S. based, and many are recognizable brand names in the worldwide (e.g. Sony, Philips, Toshiba, Honda, BMW). The new large multinationals are not only are originating in other developed countries, but there are an increasing number of multinationals based in developing countries. Table 1.3 shows the change in the home country of multinationals since 1973. The country focus on Korea’s new multinationals clearly illustrates the growth of developing country multinationals.
4. An increasing number of small firms are becoming global leaders in their field, giving rise to the mini-multinational. The management focus segment on Harry Ramsden’s illustrates the opportunities available to small firms.
5. The fall of communism and the development of free markets in Eastern Europe and the former Soviet Union create profound opportunities, challenges, and potential threats for firms.
6. The economic development of China presents huge opportunities and risks, in spite of its continued Communist control.
7. For North American firms, the growth and market reforms in Mexico and Latin America also present tremendous new opportunities both as markets and sources of materials and production.
8. The path to full economic liberalization and open markets is not without obstruction. Economic crises in Latin America, South East Asia, and Russia all caused difficulties in 1997 and 1998. In response, much trade was curtailed, and some countries imposed new controls. Malaysia, for example, suspended foreigners from trading in its equity and currency markets to “prevent destabilizing influences.” While firms must be prepared to take advantage of an ever more integrated global economy, they must also prepare for political and economic disruptions that may throw their plans into disarray.

The globalization debate: prosperity or impoverishment?

1. Is the shift toward a more integrated and interdependent global economy a good thing? While many economists, politicians and business leaders seem to think so, globalization is not without its critics. Globalization stimulates economic growth, raises the incomes of consumers, and helps to

create jobs in all countries that choose to participate in the global economy. (Your textbook is strongly in favor of free trade). Some of this growth, however, creates “sweatshop” jobs, increases pollution, and draws people from the countryside into ever more crowded cities and slums. (On some college campuses there have been student protests that the clothing sold in the bookstore is made in overseas sweatshops. In response, some college bookstores have altered their procurement decisions. But does that action change the conditions of the sweatshops or merely deny jobs to foreign workers?)

2. In developed countries, labor leaders lament the loss of good paying jobs to low wage countries. When the NAFTA agreement was signed, some politicians warned of a hearing a “giant sucking sound” as jobs left the USA for Mexico. Even if the jobs are not lost, it creates downward pressure on wages in industries where overseas production is a viable option. The availability of jobs for unskilled workers is clearly threatened when those jobs can be more efficiently performed elsewhere. One solution to this problem is to increase the education and training of workers in developed countries to maintain employment, and simply let the unskilled jobs go to locations where unskilled workers will accept lower wages.
3. Lower labor costs are only one of the reasons why a firm may seek to expand in developing countries. These countries may also have lower standards on environmental controls and workplace safety. Nevertheless, since investment typically leads to higher living standards, there is often pressure to increase safety regulations to international levels. No country wants to be known for its poor record on health and human safety. Thus supporters of globalization argue that foreign investment often helps a country to raise its standards.
4. There is also political and economic pressure on firms not to exploit labor or the environment in overseas operations. Western firms have been the subjects of consumer boycotts when it has been revealed that they, or their independent suppliers, operate at standards below that in developed countries.
5. With the development of the WTO and other multilateral organizations such as the EU and NAFTA, countries and localities necessarily cede some authority over their actions. If the USA wanted to “protect its domestic lumber industry” by preventing imports of lumber from Canada, the dispute would likely be settled by an international arbitration panel set up by the NAFTA agreement or the WTO. Because of its trade agreements, the USA would likely be forced to open its markets to importation of lower cost, higher quality Canadian lumber. While this would clearly be good for consumers, the domestic lumber industry would protest. While clearly some sovereignty has been ceded, it has been done to protect the best interests of consumers. If a nation wanted to retreat into a more protectionist position, it could clearly choose to withdraw from its international agreements.

Managing in the global marketplace:

1. As their organizations increasingly engage in cross-border trade and investment, it means managers need to recognize that the task of managing an international business differs from that of managing a purely domestic business in many ways. Countries differ in their cultures, political systems, economic systems, legal systems, and levels of economic development.
2. These differences require that business people vary their practices country by country, recognizing what changes are required to operate effectively. It is necessary to strike a balance between adaptation and maintaining global consistency, however. Coca-Cola would not be as successful, nor would Coke be Coke, if it tasted like ginseng in one country, lemon in another, and rhubarb in a third. Clearly some adaptations need to be made to correspond with local regulations and distribution systems, but some things need also remain consistent in order to benefit from economies of scale in advertising and production.
3. As a result of making local adaptations, the complexity of international business is clearly greater than that of a purely domestic firm. Firms need to decide which countries to enter, what mode of entry to use, and which countries to avoid. Rules and regulations also differ, as do currencies and languages.
4. Managing an international business is different from managing a purely domestic business for at least four reasons: 1) countries differ, 2) the range of problems and manager faces is greater and more complex, 3) an international business must find ways to work within the limits imposed by governmental intervention and the global trading system, and 4) international transactions require converting funds and being susceptible to exchange rate changes.

GLOBALIZATION

COUNTERVAILING FORCES:

Countervailing forces influence the conditions in which companies operate and their options for operating internationally. Rivalries among countries, cross-national treaties and agreements and ethical dilemmas can inhibit a firm's quest for maximum global profits.

A. Globally Standardized versus Nationally Responsive Practices:

Trends that influence the worldwide growth in international business often favor the use of a *global strategy*, i.e., standardization, thus capturing gains from *economies of scale*. On the other hand, a firm may choose to use a *multidomestic strategy*, i.e., to be nationally responsive, thus increasing its effectiveness by adjusting to the different conditions it encounters in the various countries in which it operates.

B. Country versus Company Competitiveness:

At one time the performance of a country and that of its domestic companies were considered to be mutually dependent and beneficial. However, many companies now choose to compete by seeking maximum production efficiency on a global scale, even if it means moving production activities abroad. If as a result *high-value activities* increase sufficiently in the home country, it will realize an economic gain; if not, the country's economic position will deteriorate. Countries continue to entice both domestic and foreign firms to locate activities within their borders through regulations, on the one hand, and incentives on the other.

C. Sovereign versus Cross-National Relationships:

Although governments act in their own self-interest, they may choose to cooperate with one another and even cede limited sovereignty through treaties and other agreements.

1. Countries enter into a variety of bilateral and multilateral treaties and agreements with other countries regarding commercial activities in order to gain reciprocal advantages for themselves and their domestic firms.
2. Countries enact treaties and agreements to coordinate activities along their shared borders and deal with problems that a single country acting alone cannot solve.
3. Countries enact treaties and agreements to deal with areas of concern that lie outside the territory of all countries, i.e., the non-coastal areas of the oceans, outer space and Antarctica.

Ethical dilemmas and social responsibility:

Sorting through the World of Right and Wrong in International Business:

Firms take many actions that elicit almost universal agreement about what is right or wrong. In the international arena, however, religious beliefs, social attitudes, laws, regulations and policies may vary significantly. No set of workable corporate guidelines is universally accepted and observed. An MNE may find it has either more or less latitude in making decisions in the foreign countries in which it operates.

Cultural relativism holds that ethical truths depend upon the groups holding them; thus intervention in

local traditions is seen as unethical. On the other hand, normativism holds that there are universal standards of behavior everyone should follow, thus making non-intervention unethical. From a business standpoint, two possible objectives are to (a) proactively create competitive advantages through socially responsible behavior that leads to trust and commitment and (b) avoid being perceived as irresponsible.

Looking into the future:

Seizing That Window of International Business Opportunity:

At this time there is much confusion about the future growth of international business. Nonetheless, a firm that wants to capitalize on international opportunities must not wait too long. By envisioning different ways in which the future may evolve, a company can be better prepared to develop the facilities and people needed to succeed in an uncertain environment.

Advantages and challenges of globalization:

Productivity:

Productivity is improved by producing in countries where production is most efficient. However, this often means workers in one country lose jobs as their work moves to more efficient locations.

Consumers:

Consumers benefit from a wider array of competitively priced goods. However, they have less control over supplies coming from abroad than over goods produced domestically.

Employment:

Employment may increase as economic growth and specialization take hold. However, domestic employment fluctuates according to foreign conditions (such as economic crises elsewhere that reduce demand for domestically produced goods).

The Environment:

As global consumption increases due to globalization, more natural resources deplete. Differing environmental standards across countries create opportunities for businesses to exploit resources in countries with the least amount of environmental protection regulation.

Monetary and Fiscal Conditions:

As money moves more freely, it is better able to seek out the best investment opportunities on a global scale. However, governments have less control over the inflow and outflow of funds. Furthermore, capital seems to be flowing more freely to countries with lower tax rates and less regulatory restrictions, putting additional pressures on national fiscal and monetary policies.

Sovereignty:

Globalization may undermine national sovereignty in two ways: First, contact with other countries creates more cultural borrowing and may dilute a country's cultural uniqueness. Second, countries are concerned that important decisions may be made abroad by foreign owners of domestically located firms.

What makes international business different?**Different National Environments****Legal-Political Environment:**

Companies that do business internationally are subject to the laws and political systems of each country in which they operate. When laws differ greatly from those at home, firms may encounter substantial operating problems (Blockbuster in Germany is used as an example).

Economic Environment:

Countries differ significantly in terms of their GDP per capita. Poor countries have smaller markets, less disposable income, higher illiteracy rates, and lower life expectancy rates. All these factors and others require attention and adaptation on the part of international firms.

Cultural Environment:

Country norms, based on attitudes, values, beliefs, and information processing frameworks, differ from country to country. Many of these cultural issues, such as attitude toward work and leadership styles, have a direct impact on whether a foreign firm will succeed or fail in a particular cultural setting.

Mobility:

Countries place substantial restrictions on the international movement of goods. Some countries also restrict the conversion of their currency to other currencies. Immigration laws may restrict the transfer of personnel. Mobility restrictions help make international business very different from business in a domestic setting.

Unit 3

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

Learning Objectives

1. Describe how the variation of political systems of countries often follows 'collectivist vs. individualist' and 'democratic vs. totalitarian' dimensions. That tendency can be best visualized by looking at the degree of economic and political freedom enjoyed by a country's citizens.
2. Explain the differences in economic systems between countries. Examining specifically the characteristics of market economies, command economies, mixed economies, and state-directed economies achieves that objective.
3. Examine the differences in the economic development of different countries. The chapter presents and describes economic development measures like GDP, purchasing power, and human development indices.
4. When considering international expansion, suggest that the potential for future economic growth and the growth rate may be as or more important than static measures of economic development.
5. Explain how differences in the legal systems of countries can dramatically affect the attractiveness and ease of doing business in different countries. The chapter highlights differences in protections of intellectual property (patents, copyrights, and trademarks), product safety and liability, and contract law to suggest how legal systems affect the conduct of international business.
6. Show how changes in the world order in the 1980s and 1990s affected countries in Europe, Asia, Latin America, and Africa, and how these changes present both great new opportunities and risks for international business.
7. Summarize issues that affect the attractiveness of doing business in different countries, including the benefits, costs, and risks determined by the political economy of nations.
8. Present some ethical concerns of doing business in countries that have different standards, political ideologies, economic systems, and patterns of acceptable and expected behavior (i.e. bribes).

Lessons Outlines

THE CHANGING POLITICAL ECONOMY OF INDIA

INTRODUCTION

POLITICAL SYSTEMS

Collectivism and Individualism

Democracy and Totalitarianism

ECONOMIC SYSTEMS

Market Economy

Command Economy

Mixed Economy

State-Directed Economy

LEGAL SYSTEMS

Property Rights

Country Focus: Forty Years of Corruption in Nigeria

The Protection of Intellectual Property

Management Focus: Drug Patents and the AIDS Epidemic in South Africa

Product Safety and Product Liability

Contract Law

THE DETERMINANTS OF ECONOMIC DEVELOPMENT

Differences in Economic Development

Broader Concepts of Development: Amartya Sen

Political Economy and Economic Progress

Geography, Education and Economic Development

STATES IN TRANSITION

The Spread of Democracy

The New World Order?

The Spread of Market-Based Systems

The Nature of Economic Transformation

Country Focus: Privatization in Brazil

Implications

IMPLICATIONS FOR BUSINESS

Attractiveness

Ethical Issues

Introduction:

1. As it can be pointed out in this chapter, and indeed in almost every chapter to follow, the issues that face international businesses are entirely different from those that face domestic firms. This is a point that I frequently repeat with many chapters: whether the subject is political differences, cultural differences, trade and tariff issues or even corporate makeup, the major issues of international business are issues that simply do not occur in domestic businesses. One cannot expect to understand international business by learning the tenants of domestic business and then superimposing them on an international scene. Differences between countries are profound, and they have a profound affect on how managers and firms work and act internationally. In this chapter we look at the political, economic, and legal infrastructures of different countries, while in the next chapter we will consider differences in culture, religion, and education.
2. The opening case on the political economy of India shows the difficulty nations may experience when they attempt to move from a largely state-driven economy to one of privatization. Even when change appears to be merited, the results of a particular change can be mixed and inconclusive. Changing political views on the ownership of business enterprises can have dramatic effects on economic efficiency and foreign investment.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

Political Systems:

1. There are two separate polarities to consider when discussing political systems: collectivism vs. individualism and democracy vs. totalitarianism.
2. The general premise of collectivism is that the state must manage enterprises if they are to benefit society. Democratic Socialism sees itself as part of the historical trend toward democracy and universal enfranchisement that has taken place worldwide since the 1700s. In fact, it sees socialism as the ultimate democracy-- putting faith in the common person's ability not only to vote on Election Day, but also to govern his and her workplace and community.

According to philosopher Jonathan Kandell, "What distinguishes Democratic Socialists from more radical communist groups is the unwavering belief that socialism must come through democratic means or not at all (along with all the standard individual rights to free speech and assembly). Democratic Socialists distinguish themselves from Liberals in that they feel the basic structure of capitalism is inherently biased against a large group of people and must be structurally rectified, instead of just tiny tinkering. The government must take an active, radical stance in favor of workers, equality, basic human needs, workplace democracy, and against greed, capital and property rights."

Communists generally believed that state control could only be achieved through revolution and totalitarian dictatorship, while Social Democrats worked to achieve the same goals by democratic means. Examples of communism include the Soviet Union, most Eastern European nations from 1950 to 1989, Cuba, and China. China remains the only major country in the world today still under communist rule. Social Democratic nations include Sweden, Germany, France, and Norway, although Social Democratic parties have not always held power in these nations. Don't be surprised if your students have only a vague idea about Communism. I find that many students are shocked to believe that a country could hope to control the ideology of its people by building a wall around a city (Berlin). In this day of rapid, instantaneous exchange of electronic information, the concept of a government trying to create physical barriers to control the flow of information is often difficult for them to grasp.

3. The inefficiencies of government are well known, and students can often offer many examples. (The \$100 hammer, for instance.) State owned firms promoting the public interest have had a poor track record. The reasons are often obvious: state owned firms are often protected from competition and are poorly motivated to achieve any financial self-sufficiency. Often their major purpose is to perpetuate their existence, rather than bringing anything positive to the country they are supposed to serve. Thus, both former communist and Western European countries have privatized enterprises that were previously state owned.

4. While advocated by Aristotle, individualism, in modern days was encouraged by David Hume, Adam Smith, John Stuart Mill, and most recently, Hayek and Milton Friedman. Individualism focuses on i) guaranteeing individual freedom and self-expression, and ii) letting people pursue their own economic self-interest in order to achieve the best overall good for society. The US Declaration of Independence and the Bill of Rights embody the spirit of individualism, but more familiar to today's students are forces like MTV, which encourage people the world over to vote for their favorite video—even in countries where voting in elections is impossible and the concept of voting is not understood.
5. Collectivism advocates the good of the collective group over the individual; individualism asserts the opposite. This ideological difference shapes much of recent history and especially the Cold War. [An interesting digression one can take here (at the risk of getting sidetracked) is to discuss environmentalism, in the context of collectivism vs. individualism. While one might expect that countries with a collectivist approach would have much higher environmental standards "for the common good" than individualist countries where "anyone can do what they want on their own land," the record is less clear. While the Social Democratic countries of Norway and Sweden have some of the best overall environmental records, the pollution problems in many of the former communist states are horrendous. And the US has an environmental record similar to many other social democratic countries in Western Europe. In fact, as we will see in later discussions on GATT and NAFTA, different countries' environmental standards are becoming an increasingly important issue in international trade negotiations.]
6. Democracy and totalitarianism are at different ends of a political dimension. The democratic vs. totalitarian dimension is not independent of the collectivism vs. individualism dimension. Democracy and individualism go hand in hand, as do the communist version of collectivism and totalitarianism. However, gray areas also exist; it is possible to have a democratic state where collective values predominate, and it is possible to have a totalitarian state that is hostile to collectivism and in which some degree of individualism - particularly in the economic sphere - is encouraged.
7. Democracy in its pure state, with each individual voting on every issue, has generally been replaced by representative democracy, where elected representatives vote on behalf of constituents. Yet in Switzerland many issues are decided by referendum, and in many US states referendums decided directly by voters on Election Day are becoming increasingly common. (A recent example in your state can help illustrate this point. If it is something that directly affects businesses, then an analogy can be drawn to how referendums in different countries could affect business operations and decisions.)
8. Under totalitarianism, a single political party, individual, or group of individuals monopolize the political power and do not permit opposition. There are four major forms of totalitarianism: communist, theocratic, tribal, right wing (often military). There has been a general trend away from

communist and right wing totalitarianism and towards democracy in the 1980s and 1990s. Issues relating to theocratic and tribal totalitarianism are presently at the root of some unrest in Asia and Africa.

9. A good way to discuss countries' relative political and economic freedom is to draw a diagram with political freedom on one dimension and economic freedom on the other. You can then ask students to relatively position different countries on the dimensions of economic and political freedom. (If students are assigned the "country characteristics" exercise described later, the relative positioning of firms can be a part of the exercise.)
10. The political environment of a country matters because 1) when economic freedoms are restricted so may be the ability of an international business to operate in the most efficient manner, and 2) when political freedoms are restricted there are both ethical and legal risks concerns that have to be considered.

Political Spectrum:

Forms of government range from Democracy to Totalitarianism:

Democracy:

Since democracies usually have economic freedom and legal rules that safeguard individual (and corporate) rights, they are often preferred by MNCs. Contemporary democratic political systems tend to have the following six characteristics: 1) freedom of opinion, expression, press, and freedom to organize; 2) elections in which voters decide who is to represent them; 3) limited terms for elected officials; 4) an independent and fair court system with high regard for individual rights and property; 5) a nonpolitical bureaucracy and defense infrastructure, and; 6) an accessibility to the decision-making process. Winston Churchill referred to democracy as the worst form of government—except for all others.

Political rights and civil liberties:

Political rights include fair elections and power being conferred on the people's representatives. Civil liberties include a free press, equality under the law for individuals, and personal freedom.

Stability in democracies:

Many new democracies around the world are not yet stable. Few political parties and corruption threaten the system's survival. However, 75% of all people in democracies strongly feel it is the best form of government.

Totalitarianism:

Forms of totalitarianism include fascism (Mussolini's Italy), authoritarianism (Chile under Pinochet), and communism. Communists believe in the equal distribution of wealth, which entails total government ownership and control of resources.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY**THE IMPACT OF THE POLITICAL SYSTEM ON MANAGEMENT DECISIONS:****Political Risk:**

Political risk occurs when there is a possibility that the political climate in a foreign country will change in such a way that the operations of international companies in that country will deteriorate.

A. Types and causes of political risk:

Types of political risk include government takeovers of property, operating restrictions, and agitation that damage the company's performance. Such problems can be caused by changing opinions of political leadership, civil disorder, and changes in external relations (such as animosity between the home and host country governments).

Macro and micro political risks:

If political actions are aimed only at specific foreign investments (e.g., a single foreign company), they are considered micro political risks. If they are aimed at a broad spectrum of foreign investors (e.g., when all foreign-owned private property was taken over by Cuba), they are considered macro political risks.

B. Government Intervention in the Economy:

Some governments adopt an "individualistic paradigm" and keep intervention in the economy at a minimum. Others adopt a "communitarian paradigm" wherein the government plays a larger role in the economy. They thrive on a respected, centralized bureaucracy with a stable political party or coalition in power. If a U.S. firm moves from the United States (individualistic) to Germany, Japan, or South Korea (communitarian), it may have to develop new strategies for its relationships with government, suppliers, customers, and competitors.

FORMULATING AND IMPLEMENTING POLITICAL STRATEGIES:

There are certain steps that a company must follow if it wants to establish an appropriate political strategy in its countries of operation. The steps include: 1) Identify the issue (what is the specific issue facing the firm—trade barriers, workers' rights?); 2) Define the political aspect of the issue (is it something that can be dealt with outside of politics?); 3) Assess the potential political action of other companies; 4) Identify important institutions and key individuals; 5) Formulate strategies (what are your firm's objectives and alternatives for reaching them?); 6) Determine the impact implementing the strategies (how will it affect the firm's image?); 7) Select the appropriate strategy and implement.

Economic Systems:

1. There are four broad types of economic systems: market, command, mixed, and state-directed. In reality almost all are mixed to some extent, for even the most market oriented systems have some governmental controls on business and even the most command based systems either explicitly allow some free markets to exist or have black markets for some goods and services. Yet all countries can be considered to be at some point on a continuum between pure market and pure command.

2. In a pure market economy, the goods and services that a country produces, and the quantity in which they are produced, is not planned by anyone. Rather price and quantity are determined by supply and demand. For a market economy to work, there must be no restrictions on either supply or demand - no monopolistic sellers or buyers. The recent legal battle with the federal government and Microsoft is an example of an attempt by government to remove from Microsoft what it perceived to be business restrictions that resulted in monopolistic operations.
3. In a pure command economy, the government plans what goods and services a country produces, the quantity in which they are produced, and the price at which they are sold. Resources are allocated “for the good of society.” The government owns most, if not all, businesses, including even small businesses like the bread bakery and the local farm.
4. A mixed economy includes some elements of each. In Canada, for example, while most business is privately owned and operated under market principles, health care, electrical power, and liquor distribution are run by state owned enterprises in most provinces. Over the past few decades France has chosen to inefficiently operate many business enterprises “for the good of workers and the country,” and complains vigorously to the EU when more efficient private firms from other EU countries seek to encroach on the markets these enterprises poorly serve.
5. In a state-directed economy, the government plays a significant role in directing the investment activities of private enterprises through “industrial policy.” Both Japan and South Korea are often cited as examples of state-directed economies. In both situations the government has played a significant role in directing investment. This direction has helped in the creation of some leading international firms. For a state-directed economy to work well, state bureaucrats must make better decisions than capital markets on the allocation of resources. While state bureaucrats may be able to take a longer-term perspective than capital markets, they may also prove to be intransigent and resistant to making necessary changes. The difficulties many South East Asian countries faced in 1997-98 highlight some of the limitations of a state-directed economy. Resisting whims of the market has both its good and bad points.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

Legal Systems:

1. The legal environment of a country is of immense importance to international business. A country's laws regulate business practice, define the manner in which business transactions are to be executed, and set down the rights and obligations of those involved in business transactions. Differences in the structure of law can have an important impact upon the attractiveness of a country as an investment site and/or market.
2. Control over property rights are very important for the functioning of business. Property rights refer to the bundle of legal rights over the use to which a resource is put and over the use made of any income that may be derived from that source. Property rights can be violated by either private action (theft, piracy, blackmail, Mafia) or public action (governmental bribery and corruption, nationalization). Lack of confidence in a country's fair treatment of property rights significantly increases the costs and risks of doing business.
3. The Country Focus on Corruption in Nigeria shows how a country that has huge natural resources can still remain poor when its political leaders conspire to damage its economic activity for their personal gain. High levels of corruption can naturally lead to a significant reduction in economic activity.
4. Intellectual property rights (patents, copyrights, and trademarks) are important for businesses if they are to capitalize on what they have developed. Firms like Microsoft, Levis, Coca-Cola, or McDonald's would have little reason to invest overseas if other firms in other countries were able to use the same name and copy their products without permission. The management focus article on drug patents in South Africa illustrates the issue well. By allowing the purchase of AIDS drugs from the cheapest source, the South African government was attempting to avert a health crisis. In doing so, it created a violation of international property rights that may take many years of court action to settle.
5. Different countries have different product safety and liability laws. In some cases US businesses must customize products to adhere to local standards if they are to do business in a country, whether these standards are higher or just different.
6. When product standards are lower in other countries, firms face an important ethical dilemma. Should they produce products only of the highest standards even if this puts them at a competitive disadvantage relative other producers and results in not maximizing value to shareholders? Or should they produce products that respond to local differences, even if that means that consumers may not be assured of the same levels of safety in different countries? One serious example I use involves the flame retardant nature of children's pajamas. In many countries restrictions on the level of flame retardency are very low and even nonexistent, and it is perfectly legal to manufacture that product without protective standards. Should international firms continue to manufacture to

higher protection levels, with resulting increased costs that may put them at a competitive disadvantage?

7. Differences in contract law force firms to use different approaches when negotiating contracts. In countries with common law traditions, contracts tend to be much more detail oriented and need to specify what will happen under a variety of contingencies. Common law tends to interpret legal statutes according to the past decisions and rulings of courts. The United States uses a common law system. Under civil law systems, contracts tend to be much shorter and less specific since many of the issues relating to contracts are covered in the civil code of the country. Under common law, ownership is established by use; under civil law, ownership is determined by registration. Therefore, another firm may register a product first and prevail in a bid for ownership, even though the competition had been using the product for a long time but had failed to register it.

Kinds of Legal Systems:

1. Common law. Laws are based on tradition, precedent, and custom (e.g., United States, United Kingdom).
2. Civil law. The legal system is based on a detailed set of laws that make up a code (e.g., Germany, France, Japan).
3. Theocratic law. The legal system is based on religious precepts (e.g., Iran).

Consumer Safeguards:

Liability issues are a major challenge for international firms. Different legal systems provide different safeguards for consumers. For example, a survey of 194 big Japanese manufacturers found that only 24 had ever faced a product-liability suit at home and, of those, only seven had lost. In the United States, one auto company had 250 product-liability suits in a year, but only 2 during the same time frame in Japan. (See Exercise 3.2 in the “Going Global” section at the end of the chapter)

The Legal Profession:

MNEs must use lawyers for a variety of services, such as negotiating contracts and protecting intellectual property. Some law firms have actually become international through mergers with other law firms. More commonly, law firms often establish correspondent relationships with law firms in other countries in order to provide better international services to their business customers.

Legal Issues in International Business:

Laws which govern domestic activities differ from country to country (e.g., minimum wage level, length of workweek). Laws also exist that cover cross-border activities (e.g., import duties, foreign investment regulations). Laws affect so many aspects of international business that legal issues will be addressed in more depth in several additional chapters.

The Determinants of Economic Development

1. Different countries have dramatically different levels of development, as shown in Map 2.1. GDP/capita is a good yardstick of economic activity, as it measures average value of the goods and services produced by an individual.

2. But GDP/capita does not consider the differences in costs of living. The UN's PPP index as shown in Table 2.1 shows the differences in the standards of living of people in different countries.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

The Determinants of Economic Development:

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2. But GDP/capita does not consider the differences in costs of living. The UN's PPP index as shown in Table 2.1 shows the differences in the standards of living of people in different countries.
3. A problem with both GDP/capita and PPP is that they are static in nature. From an international business perspective it is good to look at the rate of growth in the economy as well as the status of its people. Map 2.3 shows that some of the fastest growing countries economically are those have been slower to develop.
4. A broader approach to assessing the overall quality of life in different countries is the Human Development Index. This is based on life expectancy, literacy rates, and whether (based on PPP indices) incomes are sufficient to meet the basic needs of individuals. Map 2.4 shows the Human Development Index. Notice that some of the worse off countries are heavily populated and have rapidly expanding populations.
5. What is the relationship between political economy and economic progress? This is a difficult issue. One thing that is generally accepted is that innovation is the engine of long-run economic growth. Another thing that we have come to generally accept in recent years is that a market economy is better at stimulating innovation than a command economy that does not have the same types of incentives for individual initiative.
6. Innovation also depends on a strong protection of property rights, as innovators and entrepreneurs need some level of assurance that they will be able to reap the benefits of their initiative.
7. While it is possible to have innovation and economic growth in a totalitarian state, many believe that economic growth and a free market system will eventually lead a country to becoming more democratic.
8. Geography can also affect economic development. A landlocked country with an inhospitable climate, poor soil, few natural resources, and terrible diseases is unlikely to develop economically as fast as country with the opposite characteristics on each of these attributes.
9. While it can be hard to do much about unfavorable geography, education is something that governments can affect. Numerous studies suggest that countries that invest more in the education of their young people develop faster economically. Examples include Japan, South Korea and many Asian countries.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

States in Transition:

1. Since the late 1980s there have been two major changes in the political economy of many of the world's nations. First, a wave of democratic revolutions swept the world, and many of the previous totalitarian regimes collapsed. Secondly, there has been a move away from centrally planned and mixed economies towards free markets.
2. The revolutions in the USSR and Eastern Europe have (in general) moved these countries towards democracy (away from totalitarianism), towards individualism (away from collectivism), and towards mixed economies (away from command). The transitions have been difficult, however, and economic progress has not been easy. Recent elections have brought "reformed" communists back into power in some countries, and the economic problems facing the people are significant.
3. There are three main reasons for the spread of democracy. First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations. Secondly, improved information technology limited the ability of the government to control citizens' access to information. Thirdly, increases in wealth and the standard of living have encouraged citizens to push for democratic reforms.
4. While there are general movements towards democracy and open economies, this does not mean that there is necessarily going to be a homogenization of civilization. At the same time we see a further definition and development of both Islamic and Chinese civilizations.
5. The spread of market-based economic systems is not limited the dramatic changes in the former totalitarian states in Eastern Europe. In Western Europe, there has been a general trend towards privatization of state owned companies and deregulation of industry. Any recent edition of the Financial Times or the Economist will likely discuss the problems facing some previously protected and overstaffed industry.
6. During the 1980s most Latin American countries changed from being run by dictatorship to democratically elected governments. While most countries previously had erected high barriers to imports and investment (to keep multinationals from "dominating" their economies), they now mostly are encouraging investment, lowering barriers, and privatizing state owned enterprises.
7. Map 2.6, based on data from the Heritage Foundation, provides some indication of the degree to which the world has shifted towards market-based economic freedom.
8. The Country Focus on Privatization in Brazil points out the benefits of privatization that have occurred in that country. Most notable is the case of Embraer, which experienced huge losses under a state control. When the company was sold to private enterprise, it experienced a dramatic turnaround and became an economic success.

9. These transitions are creating huge opportunities for international business, as well as creating huge risks. It is not clear what direction future changes will take, and if these will be entirely favorable for business.
10. The shift toward a market-based economic system typically involves at least three distinct activities: deregulation, privatization, and legal enforcement of property rights. Deregulation involves removing restrictions on the free operation of markets. Privatization transfers the ownership of state property into the hands of private investors. In order to attract investment and protect the interests of the private enterprise encouraged by the first two activities, changes typically need to be made to legal systems to protect the property rights of investors and entrepreneurs.

Implications for Business:

1. The political, economic, and legal environment of a country clearly influence the attractiveness of a country. A country's attractiveness can be best evaluated by looking at the benefits, costs, and risks of doing business in that country.
2. The long run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers, and the likely future wealth of consumers. By identifying and investing early in a potential future economic star, firms may be able to gain first mover advantages and establish loyalty and experience in a country. Two factors that are reasonably good predictors of a country's future economic prospects are its economic system and property rights regime.
3. A number of political, economic, and legal factors determine the costs of doing business in a country. Political costs can involve the cost of paying bribes or lobbying for favorable or fair treatment. Economic costs relate primarily to the sophistication of the economic system, including the infrastructure and supporting businesses. Regarding legal factors, it can be more costly to do business in countries with dramatically different product, workplace, and pollution standards, or where there is poor legal protection for property rights.
4. Political risk is the likelihood that political forces will cause drastic changes in a country's business environment that adversely affects the profits or other goals of the business. Economic risk is the likelihood the economic mismanagement will likewise affect a business. Legal risk is the likelihood that a trading partner may opportunistically break a contract or expropriate intellectual property rights.
5. As a general point, it should be noted that the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations, whereas the risks are greater in less developed and politically unstable nations. The assessment is complicated, however, by the fact that the potential long-run benefits bear little relationship to a nation's current stage of economic development or political stability. Rather, they are dependent upon likely future economic growth rates. In turn, among other things, economic growth appears to be a function of a free market system and a country's capacity for growth (which

may be greater in less developed nations). This leads one to the conclusion that, other things being equal, the benefit, cost, and risk tradeoff is likely to be most favorable in the case of politically stable developing nations that have free market systems. It is likely to be least favorable in the case of politically unstable developing nations that operate with a mixed or command economy.

6. One ethical concern regards whether firms should invest in countries where the government represses its citizens in political and/or economic freedom. While some argue that investing in these countries is implicitly supporting the repression, others argue that the best way to encourage change is from within, and that increasing economic development of the country will lead to greater political and economic freedoms.
7. A second ethical concern regards whether an international firm should adopt consistent and high levels of product safety, worker safety, and environmental protection worldwide, or whether they should focus only on meeting local regulations. If they adopt high standards, and subsequently lose business to other competitors with lower standards, was this an ethically correct position for it to take in light its requirements to act in the best interest of shareholders and provide advancement opportunities for its personnel? If the question is taken to extremes, is it ethical for a company to make a decision that might ultimately put it out of business and put its employees out of work?
8. Another ethical concern regards whether firms should pay bribes to governmental officials or business partners in exchange for business access. Should paying bribes be completely avoided, or are bribes just another cost of doing business that "grease the wheels" and lead to benefits for both the firm and consumers. If bribes are an integral part of business transactions in a country, is a firm being culturally insensitive and elitist if it finds bribes repulsive and refuses to pay them? One answer is that bribes are illegal, according to the regulations of the US government. Again, these are considerations that are not faced by executives in domestic firms and only occur in international business.
9. The closing case illustrates the challenges involved in Microsoft's entry into China. Although the use of pirated software was rampant in China, the company found little solace in the courts when its tried to stop that piracy, despite prolonged, expensive attempts. One of the obvious problems is that the price of most of Microsoft's products far exceeds the financial ability of most Chinese. By steadfastly adhering to its principles of intellectual ownership, Microsoft gave birth to a competitor—the Linux operating system that appeared to be a good, cheap alternative to the Chinese.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

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2. But GDP/capita does not consider the differences in costs of living. The UN's PPP index as shown in Table 2.1 shows the differences in the standards of living of people in different countries.
3. A problem with both GDP/capita and PPP is that they are static in nature. From an international business perspective it is good to look at the rate of growth in the economy as well as the status of its people. Map 2.3 shows that some of the fastest growing countries economically are those have been slower to develop.
4. A broader approach to assessing the overall quality of life in different countries is the Human Development Index. This is based on life expectancy, literacy rates, and whether (based on PPP indices) incomes are sufficient to meet the basic needs of individuals. Map 2.4 shows the Human Development Index. Notice that some of the worse off countries are heavily populated and have rapidly expanding populations.
5. What is the relationship between political economy and economic progress? This is a difficult issue. One thing that is generally accepted is that innovation is the engine of long-run economic growth. Another thing that we have come to generally accept in recent years is that a market economy is better at stimulating innovation than a command economy that does not have the same types of incentives for individual initiative.
6. Innovation also depends on a strong protection of property rights, as innovators and entrepreneurs need some level of assurance that they will be able to reap the benefits of their initiative.
7. While it is possible to have innovation and economic growth in a totalitarian state, many believe that economic growth and a free market system will eventually lead a country to becoming more democratic.
8. Geography can also affect economic development. A landlocked country with an inhospitable climate, poor soil, few natural resources, and terrible diseases is unlikely to develop economically as fast as country with the opposite characteristics on each of these attributes.
9. While it can be hard to do much about unfavorable geography, education is something that governments can affect. Numerous studies suggest that countries that invest more in the education of their young people develop faster economically. Examples include, Japan, South Korea and many Asian countries.

Other regulatory issues:

1. Countries often impose protectionist policies, such as tariffs, quotas, and other trade restrictions, to give preference to their own products and industries.

2. Tax systems influence the attractiveness of investing in a given country and affect the relative level of profitability for the MNC. Tax issues include: foreign tax credits, holidays and exemptions, depreciation allowances, and profit or value added tax rates. Definitions of key items such as income and profit vary across countries, as do reporting requirements.
3. The level of government involvement in the economic and regulatory environment varies a great deal among countries and has a varying impact on management practices.

The Technological Environment:

- A. In a global information society, it is clear that corporations must incorporate into their strategic planning and their everyday operations the accelerating macro-environmental phenomenon of technoglobalism, in which the rapid developments in information and communication technologies (ICTs) are propelling globalization and vice-versa. Investment-led globalization is leading to global production networks, which results in global diffusion of technology to link parts of the value-added chain in different countries.
- B. The Internet is propelling electronic commerce around the world. In fact, the ease of use and pervasiveness of the Internet raises difficult questions about ownership of intellectual property, consumer protection, residence location, taxation, and other issues.
- C. New technology specific to a firm's products represents a key competitive advantage to firms and challenges international businesses to manage the transfer and diffusion of proprietary technology, with its attendant risks. Whether it is a product, a process, or a management technology, an MNC's major concern is the appropriability of technology—that is, the ability of the innovating firm to profit from its own technology by protecting it from competitors. Especially difficult is managing the transfer of technology to venture partners who might become future competitors.
- D. An MNC can enjoy many technological benefits from its global operations. Advances resulting from cooperative research and development (R&D) can be transferred among affiliates around the world, and specialized management knowledge can be integrated and shared. However, the risk of technology transfer and pirating is considerable and costly.
- E. Although firms face few restrictions on the creation and dissemination of technology in developed countries, less developed countries often impose restrictions on licensing agreements, royalties, and so forth, and have other legal constraints on patent protection.
- F. The most common methods of protecting proprietary technology are through patents, trademarks, trade names, copyrights, and trade secrets. The International Convention for the Protection of Industrial Property, often referred to as the Paris Union, is adhered to by over 80 countries for protection of patents.

NATIONAL DIFFERENCES IN POLITICAL ECONOMY

Political risk:

1. Political risks are any governmental actions or politically motivated events that adversely affect the long-run profitability or value of firms doing business.
2. An important aspect of the political environment is the phenomenon of ethnicity – a driving force behind the political instability around the world. Managers must understand the ethnic and religious composition of the host country in order to anticipate situations of political and general instability.
3. Nationalization refers to the forced sale of the MNCs assets to local buyers, with some compensation to the firm. Expropriation occurs when the local government seizes the foreign-owned assets of the MNC, providing inadequate compensation, if any at all.
4. Macro political risk events are those that affect all foreign firms doing business in a country or region; e.g., terrorism, the use or threat of use of anxiety inducing violence for political purposes. Micro political risk events are those that affect one industry or company or a few companies.
5. Seven typical political risk events common today are:
 - a. Expropriation without prompt and adequate compensation
 - b. Forced sale of equity to host country nationals, usually at or below depreciated book value
 - c. Discriminatory treatment against foreign firms in applying laws and regulations
 - d. Barriers to repatriation of funds (profits or equity)
 - e. Loss of technology or intellectual property rights
 - f. Interference in managerial decision-making
 - g. Dishonesty by government officials

Political risk assessment:

1. Global companies must commit some form of political risk assessment in order to manage their exposure to risk and to minimize financial losses.
2. Risk assessment by multinational corporations usually takes two forms: the use of experts or consultants and the development of internal staff and in-house capabilities. Both means may be used. The focus must be on monitoring political issues before they become headlines. The ability to minimize negative effects on the firm or to be the first to take advantage of opportunities is greatly reduced once developments have been reported in the news.
3. An additional technique for assessing political risk is the use of computer risk modeling. The in-house staff at American Can, for example, uses the PRISM system (Primary Risk Investment Screening Matrix), which creates an index of desirability based on feedback from overseas managers and consultants on over 200 variables. The countries with the most favorable PRISM indices are then considered by American Can for investment.

4. To analyze their data on potential risks, some companies attempt to quantify variables into a ranking system among countries as input to investment decisions. Scores are based on criteria including the political and economic environment, domestic economic conditions, and external economic relations. An actual risk ranking of selected countries is shown in Exhibit 1.2: Comparative Country Risk Rankings.
5. One drawback to these quantitative systems is that they rely on information based primarily on past events. Still another method that is designed to be more rapidly responsive to and to predict political changes is an early warning system. The early warning system technique of assessing risk involves the use of lead indicators to predict possible political dangers, such as riots, pending import-export restrictions, etc.
6. For autonomous international subsidiaries, most of the impact from political risks will be at the level of ownership and control of the firm. For global firms, the primary risks are likely to be from restrictions (on such things as imports, exports, and currency) with the impact of the local level of the firm's transfers of money, products, or component parts.

Managing political risk:

1. After assessing the potential political risk of investing or maintaining current operations in a country, managers face perplexing decisions on managing political risk. On one level, they can decide to suspend their firm's dealings with a certain country at a given point – either by the avoidance of investment or by the withdrawal of current investment (by selling or abandoning plants and assets). On another level, if they decide that the risk is relatively low in a particular country or that a high-risk environment is worth the potential returns, they may choose to start (or maintain) operations there and to accommodate that risk through adaptation to the political regulatory environment. That adaptation can take many forms, each designed to respond to the concerns of a given local area.
2. Taoka and Beeman suggested these means of adaptation:
 - a. Equity sharing includes the initiation of joint ventures with nationals to reduce political risks.
 - b. Participative management refers to actively involving nationals, including those in labor organizations or government, in the management of the subsidiary.
 - c. Localization of the operation by modifying the subsidiary's name, management style, and so forth, to suit local tastes. Localization seeks to transform the subsidiary from a foreign firm to a national firm.
 - d. Development assistance includes the firm's active involvement in infrastructure development (foreign-exchange generation, local sourcing of materials or parts, management training, technology transfer, securing external debt, and so forth).

3. In addition to avoidance and adaptation, two other means of risk reduction available to managers are dependency and hedging.
 - a. Dependency - keeping the subsidiary and host nation dependent on the parent corporation. It can be maintained with four methods:
 1. Input control - parent controls the key inputs.
 2. Market control - parent controls means of distribution.
 - a. Position control - key positions in the hands of expatriate or home office managers.
 - b. Staged contribution strategies - parent announces planned increased investment in the host country for successive years.
 - c. Hedging - (minimizing losses associated with political events) can take place through:
 1. Political risk insurance - an insurance policy offered in most industrialized countries
 2. Local debt financing - firm can withhold debt repayment in lieu of compensation for losses incurred to political risk factors.

Managing Terrorism Risk:

1. Companies have developed a number of techniques for managing the risk of terrorism, including developing a benevolent image through charitable contributions to the local community; minimizing publicity in host countries; maintaining a low profile; putting together teams to monitor patterns of terrorism around the world; and increasing security measures abroad.

Economic risk:

1. A country's level of economic development generally determines its economic stability and therefore its relative risk to a foreign firm.
2. A country's ability or intention to meet its financial obligations determines its economic risk. The economic risk incurred by a foreign corporation usually falls into one of two main categories; its investment in a specific country may become unprofitable (1) if the government abruptly changes its domestic monetary or fiscal policies or (2) if the government decides to modify its foreign-investment policies. The latter situation would threaten the ability of the company to repatriate its earnings and would create a financial or interest-rate risk.
3. The risk of exchange-rate volatility results in currency translation exposure to the firm when the balance sheet of the entire corporation is consolidated and may cause a negative cash flow from the foreign subsidiary.
4. Currency translation exposure occurs when the value of one country's currency changes relative to another.

5. The four primary methods of analyzing economic risk (recommended by John Mathis, senior financial policy analyst for the World Bank), of a country's creditworthiness, are: quantitative, qualitative, combination of both, and the checklist approach.
6. The quantitative method attempts to statistically measure a country's ability to honor its debt obligation by assigning different weights to economic variables to produce a composite index used to monitor the country's creditworthiness over time. The qualitative approach evaluates a country's economic risk by evaluating the competence of its leaders and by analyzing the types of policies they are likely to implement.

Unit 4

DIFFERENCES IN CULTURE**Learning Objectives:**

1. Provide a basis for understanding what culture is, the norms and values of a society, and how these affect interpersonal dealings.
2. Describe differences in the social structures of people and businesses in different countries.
3. Describe the heritage and key philosophies underlying the major religions of world, and discuss the economic implications of these religious beliefs both for a nation's economy and for the practice of business in countries with different religions.
4. Introduce how a country's language and education are intertwined with its culture.
5. Show that culture is not a constant, but evolves over time.
6. The key reason to describe aspects of culture, social structure, religion, language, and education is to provide a basis for understanding 1) the importance of cross-cultural literacy and 2) how competitive advantage can be affected.
7. The connection between culture and competitive advantage has important implications for deciding where a firm may want to locate facilities and expand its presence in the market.

Lecture Outline:

OPENING CASE: Guanxi—Ties that Bind

INTRODUCTION

WHAT IS CULTURE?

Values and Norms

Culture, Society, and the Nation-State

The Determinants of Culture

SOCIAL STRUCTURE

Individuals and Groups

Social Stratification

RELIGIOUS AND ETHICAL SYSTEMS

Christianity

Islam/ Country Focus: Islamic Banking in Pakistan

Hinduism

Buddhism

Confucianism

LANGUAGE

Spoken Language

Unspoken Language

EDUCATION

CULTURE AND THE WORKPLACE

Hofstede's Model

Evaluating Hofstede's Model

CULTURAL CHANGE

Management Focus: Matsushita's and Japan's Changing Culture

IMPLICATIONS FOR BUSINESS

Cross-Cultural Literacy

Culture and Competitive Advantage

Culture and Business Ethics

CHAPTER SUMMARY

CRITICAL DISCUSSION QUESTIONS

CLOSING CASE: DISNEY IN FRANCE

Introduction:

1. The focus of this chapter is on culture. Although many differences in culture are obvious, some are subtler. Students are often not aware of their own culture. It describes some of the underlying characteristics of a country that help define the values and norms of a society. This affects not only how an individual from one country must adapt to work in another country, but also how organizations must recognize how cultural differences affect the way they work with other organizations. That aspect is described in the opening case. The rule of law, so common in countries of the West, does not work well in China, where personal relationships and connections are the key to getting things done. That concept is difficult for American businessmen to understand because they have been trained to treat everyone as equal, and to seek the solace of the court system when problems arise.
2. Two themes run through the chapter: 1) cross-cultural literacy is critical to success in a foreign country and 2) the culture of a country can directly and indirectly affect the costs of doing business in country.
3. The closing case helps to highlight a number of cultural blunders that have affected the success of EuroDisney. It also implies that a company that has been so successful with similar enterprises elsewhere (Japan, for instance) as Disney had been, still needs to be sensitive to the cultures of the country in which it is doing business. Much of the reason for Disney's failure was its corporate ego that believed it could get things done by a "kick-down-the-door" mentality. Failure to recognize important cultural differences almost caused the demise of EuroDisney.

DIFFERENCES IN CULTURE

What is Culture?

1. Culture has been defined a number of different ways. In this course we will view culture *as a system of values and norms that are shared among a group of people and that when taken together constitute a design for living.*
2. While culture is a characteristic of society as a whole, it shapes individual behavior by identifying appropriate and inappropriate forms of human interaction.
3. The fundamental building blocks of culture are values and norms.
4. Values are abstract ideas about what a society believes to be good, right, and desirable. As was discussed in Chapter 2, values affect political and economic systems as well as culture. Values include attitudes towards concepts like freedom, honesty, loyalty, justice, responsibility, and personal relations including marriage.
5. Norms are social rules and guidelines that prescribe the appropriate behavior in particular situations. Norms shape the actions of people towards one another. Norms can be divided into folkways and mores.
6. Folkways are the routines conventions of everyday life, but generally have little moral significance. Examples would be dress, eating habits, and social graces. Foreigners may be easily excused for making a few *faux pas*. Timeliness is a good example, and you can discuss when timeliness is critical (test days) as well as when one may be expected to be "fashionably late." If students come from different parts of the country or world, you can ask for opinions on when they should arrive for a party if the invitation says 8pm. Even typically American students have different concepts about lateness. The concept of time as a commodity is peculiar to Western society. Time can be spent, saved, wasted. That is quite different from many other societies, especially some areas of Latin America, where time is seen as an item to be enjoyed and savored.
7. Mores are more serious standards of behavior, the breaking of which may be very inappropriate or even illegal. Examples would be theft, adultery, murder, or use of mind-altering substances (including alcohol, caffeine, and marijuana). Mores can vary greatly between countries: what in one country may be viewed as an innocent flirt in another may constitute a serious affront to someone's dignity or even harassment. While it is acceptable, and even expected, to consume alcohol with business associates in Japan, where evening business contacts often border on drunkenness, such actions would be disallowed in the United Arab Emirates.
8. Norms and values are an evolutionary product of a number of factors that are at work in a society, including political and economic philosophy, social structure, religion, language, and education. Culture affects both of these factors and is affected by them.
9. The nation-state is only a rough approximation of a culture. Within a nation-state multiple cultures can easily exist (as we can only too painfully see in the former Yugoslavia), and cultures can also cut

across national borders. That can often be easily illustrated by describing the differences that exist between people in a country. It is quite easy to get a class of students in the Western US to agree that the people in New York are really different and generally rude, while Eastern students will comment on Californians or Southerners, etc. Likewise, students in Stockholm will have clear opinions about how different Swedes are from the far North or far South. In virtually any country or state students will easily be able to describe the differences between city-folks and country-folks, and some students will “defend” their culture while making disparaging remarks about the other.

The Nation as a Point of Reference:

Each country has cultural variations within its borders. However, cultural differences within countries tend to be considerably less than across countries. Therefore it makes sense to talk about and compare national cultures.

Cultural Formation and Dynamics:

Cultural norms are passed down from generation to generation. By age 10, most children have their value system (largely supplied by their parents) in place. However, cultures also change over time—sometimes due to increased exposure to cultural norms of other countries. When a change in culture is imposed by a foreign nation, it is considered cultural imperialism.

Language as a Cultural Stabilizer:

Language is a key component of culture. In areas that speak the same language, similar cultural attitudes spread quickly. Countries that have many competing languages within their borders tend to be more culturally diverse.

Religion as a Cultural Stabilizer:

Religion helps shape cultural values. Religion also affects business practices across countries. It may determine what days businesses must be closed, working hours, and what kinds of foods will be consumed.

Social Structure:

1. The social structure of a country can be described along two major dimensions: individualism vs. group and degree of stratification into classes or castes.
2. A focus on the individual and individual achievement is common in many Western societies. In Chapter 2 we discussed the implications of this for political and economic systems. An emphasis on individual achievement has positive and negative implications. On the positive side, the dynamism of the US economy owes much to people like Sam Walton, Steve Jobs, and Bill Gates - people who took chances, tried new things, succeeded, and encouraged others to do likewise. On the other hand, individualism can lead to a lack of company loyalty and failure to gain company-specific knowledge, competition between individuals in a company rather than team building, and limitation of people's ability to develop a strong network of contacts within a firm.
3. In sharp contrast to the Western emphasis on the individual, in many Asian societies the group is the primary unit of social organization. While in earlier times the group was usually the family or the village, today the group may be a work team or business organization. In a social setting, Asian

employees may often say they work for Sony, while a Western employee may say he/she is an electrical engineer. In Asia, the worth of an individual is more linked to the success of the group rather than individual achievement. This emphasis on the group may discourage job switching between firms, encourage lifetime employment systems, and lead to cooperation in solving business problems. On the other hand, it tends to suppress individual creativity and initiative.

4. All societies have some sort of stratification, where individuals in higher strata or castes are likely to have a better education, standard of living, and work opportunities. What matters is less what these strata are, but rather the mobility between strata and the significance of strata levels for business.
5. The mobility permitted by culture affects whether individuals can move up (or down) in strata, and can limit the types of jobs and education available. In the US individuals are very mobile ("anyone can become president"), in Britain there is less mobility, and the caste system in India severely limits mobility. Despite the laws against it, the effects of the caste system in India still exist today, and are especially prevalent in the practice of people in non-urban areas.
6. The significance of the social strata can have important implications for the management and organization of businesses. In cultures where there is a great deal of consciousness over the class of others, the way individuals from different classes work together (i.e. management and labor) may be very prescribed and strained in some cultures (i.e. Britain), or have almost no significance in others (i.e. Japan). The class of a person may be very important in some hiring and promotion decisions, particularly in sales organizations where the person will be dealing with customers that may also come from a particular class.

BEHAVIORAL PRACTICES AFFECTING BUSINESS:

Social Stratification Systems:

Every culture values some people more highly than others. What determines a person's ranking (or social stratification) varies widely from country to country. Sometimes a person's ranking is determined by birth (ascribed group membership) and sometimes by other factors such as achievement, political affiliation, religion, or other factors (acquired group membership). Social stratification may help determine a firm's target market, human resource policies, and other activities. Below are some cultural characteristics that often affect a person's social ranking.

1. **Role of competence:** Countries like the United States usually base a person's eligibility for jobs and promotions on their competence. This usually creates a working environment driven by competition. Other countries use other criteria. For example, Japan emphasizes seniority in promotion decisions—which leads to less competition based on performance.
2. **Gender-based groups:** Different countries have different attitudes toward the role of males and females in society. Recall the PRI case and the attitude toward women in the Middle East. In Afghanistan, the 1996 takeover by religious fundamentalists led to prohibiting women from attending school and working.

3. **Age-based groups:** While in many countries age is believed to be associated with wisdom, mandatory retirement at 60 or 65 in the United States suggests youth has a professional advantage. Our preference for youth is also illustrated in the abundance of products sold in the United States to help people look younger.
4. **Family-based groups:** In some societies, an individual's acceptance depends on the family's social status, not the individual's achievements. In such cultures, family-owned businesses and family-based business associations are more common. Often it may be difficult for non-family members to move up in the business.
5. **Occupation:** In each society, some occupations carry greater economic and social prestige than others. For example, in Korea and Japan greater prestige is accorded university professors than in the United States and the United Kingdom. Cultural differences may dictate the number and qualifications of individuals seeking a specific position.

Motivation

Members of different cultures may be motivated by different factors. Leisure and wealth, for example, are valued differently across cultures. Some workers may be motivated to higher productivity in order to enjoy greater leisure. In other cultures, workers may be motivated to higher productivity in order to make more money, as discussed below.

1. **Materialism and leisure.** Max Weber argued that religion and work ethic were related. According to him, Calvinist thought placed greater emphasis on the importance of material blessings and led to a society that was more motivated to work to achieve economic success. In such societies, workers put in longer hours, take fewer vacations, and are loath to "retire." In rural India, however, living a simple life with minimum material achievements is a desirable end in itself.
2. **Expectation of success and reward.** People will usually work harder at any task when the reward for success is high compared to failure. In certain cultures where the probability of economic failure is almost certain and the rewards for success are low, work will often be viewed as necessary but unsatisfying, and motivation to work is low.
3. **Masculinity index.** A worker's motivation will depend on whether s/he has a "live to work" attitude (high masculinity) or a "work to live" attitude (low masculinity). For example, a purchasing manager from a low masculinity country will emphasize smooth social relations, while a manager from a high masculinity culture would emphasize lowering costs or speeding delivery.
4. **Need hierarchy.** What motivates people changes according to their perceived needs? Lower-order needs (such as food and shelter) are more important motivators and must be mostly filled before needs for peer acceptance and self-actualization becomes powerful motivators.

Relationship Preferences:

Attitudes toward relationships are also affected by culture. These attitudes will also affect work behavior from country to country.

1. **Power distance.** In high power-distance countries, superiors and subordinates have little interaction. Managers tend to be autocratic or paternalistic. In low power-distance countries, workers and managers prefer a more consultative management style.
2. **Individualism versus collectivism.** Workers in countries high on individualism will prefer not to be dependent on their firm and will strive for more personal time, freedom, and challenge. Workers in countries high on collectivism will be more dependent on their firms for training, benefits, and good working conditions. When collectivism is high, companies find that successful advertising should express group (not individual) values.

Risk-Taking Behavior:

Three cultural aspects affect a country's attitude toward risk-taking behavior: uncertainty avoidance, trust, and fatalism.

1. **Uncertainty avoidance.** In countries high on uncertainty avoidance, workers prefer set rules which are not to be broken and tend to stay with the same company a long time. When uncertainty avoidance is low, workers will “go out on a limb” more frequently and will be quicker to change jobs to improve their careers.
2. **Trust.** Some cultures (such as Norway) tend to be trusting of other people. Other cultures (such as Brazil) tend to not trust others. The lower the trust, the higher the cost of doing business since managers have to spend time trying to foresee every possible precaution they must take to reduce the possibility of being tricked.
3. **Fatalism.** If people feel strongly that they control their own destiny, they will tend to work hard to achieve their goals and aspirations. In fatalistic countries where it is believed that one's destiny is pre-determined, people will be less likely to try to alter their conditions or work toward a different future. Fatalists believe that whatever God wills will happen and that trying to change God's will is futile.

Information and Task Processing:

People process information and reach conclusions differently. So do cultures.

1. **Perception of cues.** The precision of a language affects the way cues are conveyed. Some cultures are therefore more precise in conveying certain ideas than other cultures. For example, in Arabic there are more than 6000 different words for camels, their body parts, and the equipment associated with them. Arabic speakers can note things about camels that other language speakers cannot.
2. **Obtaining information.** Low-context cultures (such as the United States and northern Europe) tend to consider as relevant only information directly related to the decision at hand. High-context cultures place higher value on peripheral information.
3. **Information processing.** Cultures categorize information differently. In the United States, telephone directories are alphabetized by last name—in Iceland, they are alphabetized by first

name. Monochronic countries do their processing sequentially, finishing one item before starting another. Polychronic cultures work simultaneously with all the tasks they face.

DIFFERENCES IN CULTURE

Religious and Ethical Systems:

1. Religion can be defined as a system of shared beliefs and rituals that are concerned with the realm of the sacred. Ethical systems refer to a set of moral principles, or values, that are used to guide and shape behavior. The ethical practices of individuals within a culture are often closely intertwined with their religion. While there are literally thousands of religions worldwide, four that have the largest following will be discussed: Christianity, Islam, Hinduism, and Buddhism. Confucianism, while not a religion, influences behavior and shapes culture in many parts of Asia. Map 3.1 shows dominant religions across the world.
2. Christianity is the largest religion and is common throughout Europe, the Americas, and other countries settled by Europeans. Within Christianity there are three major branches: Protestant, Roman Catholic, and Eastern Orthodox. At the turn of the century Weber suggested that it was the "Protestant work ethic" that was the driving force of capitalism. This focus on hard work, wealth creation, and frugality encouraged capitalism while the Catholic promise of salvation in the next world did not foster the same kind of work ethic. The Protestant emphasis on individual religious freedom, in contrast to the hierarchical Catholic Church, was also consistent with the individualist economic and political philosophy discussed in Chapter 2.
3. Islam has the same underlying roots of Christianity (Christ is viewed as a prophet), and suggests many of the same underlying societal mores. Islam, however, extends this to more of an all-embracing way of life that governs one's being. It also prescribes many more "laws" on how people should act and live. These are laws that are entirely counter to the US "separation of church and state." In Islam people do not own property, but only act as stewards for God and thus must take care of that with which they have been entrusted. They must use property in a righteous, socially beneficial, and prudent manner; not exploit others for their own benefit; and they have obligations to help the disadvantaged. Thus while Islam is supportive of business, the way business is practiced is strictly prescribed. For instance, no interest may be paid on business loans. The country focus on Pakistan illustrates how banks deal with, and overcome, that restriction.
4. Hinduism, practiced primarily on the Indian sub-continent, focuses on the importance of achieving spiritual growth and development, which may require material and physical self-denial. Since Hindus are valued by their spiritual rather than material achievements, there is not the same work ethic or focus on entrepreneurship found in some other religions. Likewise, promotion and adding new responsibilities may not be the goal of an employee, or may be infeasible due to the employee's caste.
5. Buddhists also stress spiritual growth and the afterlife, rather than achievement while in this world. Buddhism, practiced mainly in Southeast Asia, does not support the caste system, however, so

individuals do have some mobility not found in Hinduism and can work with individuals from different classes.

6. Confucianism, practiced mainly in China, teaches the importance of attaining personal salvation through right action. Unlike religions, Confucianism is not concerned with the supernatural and has little to say about the concept of a supreme being or an afterlife. The needs for high moral and ethical conduct and loyalty to others are central in Confucianism. Three key teachings of Confucianism - loyalty, reciprocal obligations, and honesty - may all lead to a lowering of the cost of doing business in Confucian societies. The close ties between Japanese auto companies and their suppliers, called keiretsus, have been an important ingredient in the Japanese success in the auto industry. They have facilitated loyalty, reciprocal obligations, and honesty. In countries where these relationships are more adversarial and not bound by these same values, the costs of doing business are probably higher.

Language:

1. The language of a society allows it to communicate but also directs the attention of people towards certain features of the world and human interactions. A good example is how the Inuit have 24 words for snow, but no word for the overall concept. Language helps describe how different people see the world.
2. While English is clearly the language of international business, knowing at least some of the local language can greatly help when working in another country. In some situations knowing the local language can be critical for business success. Knowledge of the local language is often taken as an indication that the businessperson is willing to meet the local firm “on its own court.”
3. Unspoken language can be just as important for communication. Using a few facial expressions and hand gestures to the class can illustrate the point. The fact that these can have different interpretations in different cultures, and that many of these actions may be automatic or reflexive, obviously complicates international communication. Not only may the person you are dealing with be unintentionally sending non-verbal signals that you do not understand or find misleading, you may be unconsciously sending your own signals. One example I have used in class is to show different perceptions of “personal space” in communications. I have a conversation with one student (about sports or the weather) with us standing “a long distance apart” and a similar conversation with another student with our faces only a few inches apart. Most of the class finds both of these extreme, although a few reserved Midwesterners will find the long distance quite acceptable. Students from different countries will also comment on their perceptions, and how distance also varies with familiarity with the person.

Education:

1. Schools, as a part of the social structure of a society, and one that students are exposed to in their formative years, convey many cultural values and norms.

2. The knowledge base, training, and educational opportunities available to a country's citizens can also give it a competitive advantage in the market and make it a more or less attractive place for expanding business. In nations that have a ready trained workforce for particular types of jobs, it is easier to start operations than in nations where an investor will also have to undertake time-consuming and costly training.
3. Map 3.3 shows the literacy rates in the world. Although there is not a perfect correspondence between educational spending and literacy rates, a relation does exist, and spending on education does give an indication of a country's commitment to education.

DIFFERENCES IN CULTURE

Information and Task Processing:

People from different cultures obtain, perceive, and process information in different ways; thus, they may also reach different conclusions.

Perception of Cues:

People identify things by means of their senses in various ways with each sense. The particular cues used vary both for physiological and cultural reasons. [For example, the richer and more precise a language, the better one's ability to express subtleties.]

Obtaining Information:

Language represents a culture's means of communication. In a low-context culture, people rely on first-hand information that bears directly on a decision or situation; people say what they mean and mean what they say. In a high-context culture, people also rely on peripheral information and infer meaning from things communicated indirectly; relationships are very important. [For example, while Germany is considered to be a low-context culture, Saudi Arabia is considered to be a high-context culture.]

Information Processing:

All cultures categorize, plan and quantify, but the ordering and classification systems they use often vary. In monochronic cultures (e.g., northern Europeans) people prefer to work sequentially, but in polychronic cultures (e.g., southern European) people are more comfortable working on multiple tasks at one time. Likewise, in some cultures people focus first on the whole and then on the parts; similarly, in idealistic cultures people will determine principles before they attempt to resolve issues, but in pragmatic cultures they will focus more on details than principles.

STRATEGIES FOR DEALING WITH CULTURAL DIFFERENCES:

Once a company identifies cultural differences in the foreign countries in which it operates, must it alter its customary practices?

Making Little or No Adjustment:

Some countries are relatively similar to one another because they share the same language, religion, geographical location, ethnicity and/or level of economic development. If products and operations do not run counter to deep-seated attitudes, or if the host country is willing to accept foreign customs as a trade-off for other advantages, significant adjustments may not be required. Generally, a company should expect to have to consider fewer adjustments when moving within a culturally similar cluster than when it moves from one distinct cultural cluster to another.

Communications:

Problems in communications may arise when moving from one country to another, even though both countries share the same official language, as well as when moving from one language to another.

Spoken and Written Language:

Translating one language into another can be very difficult because (a) some words do translate directly, (b) the common meaning of words is constantly evolving, (c) words may mean different things in different contexts and (d) a slight misuse of vocabulary or word placement may change meanings substantially. Poor translations may have tragic consequences.

Silent Language:

Silent language incorporates the wide variety of nonverbal cues through which messages are sent—intentionally or unintentionally. Color associations, the distance between people during conversations, the perception of time and punctuality, a person's perceived status and kinesics (body language) are all significant. Misunderstandings in any of these areas can have a very negative impact.

Culture Shock:

Culture shock represents the trauma one experiences in a new and different culture because of having to learn to cope with a vast array of new cues and expectations.

Reverse culture shock occurs when people return home, having accepted the culture encountered abroad and discovering that things at home have changed during their absence

Company and Management Orientations:

Whether and to what extent a firm and its managers adapt to foreign cultures depends not only on the conditions within those cultures but also on the policies of the company and the attitudes of its managers.

Polycentrism:

Polycentrism represents a managerial approach in which foreign operations are granted a significant degree of autonomy in order to be responsive to the uniqueness of local cultures and other conditions.

Ethnocentrism:

Ethnocentrism represents a belief that one's own culture is superior to others, and that what works at home should work abroad. Excessive ethnocentrism may lead to costly business failures.

Geocentrism:

Geocentrism represents a managerial approach in which foreign operations are based on an informed knowledge of both home and host country needs, capabilities and constraints.

Strategies for Instituting Change:

Companies may need to transfer new products and/or operating methods from one country to another in order to gain or maintain a competitive advantage. To maximize the potential benefits of their foreign presence, firms need to treat learning as a two-way process and transfer knowledge from host countries back home as well as from home to host countries.

Value System:

The more change upsets important values, the more resistance it will encounter. Accommodation is much more likely when changes do not interfere with deep-seated customs.

Cost Benefit of Change:

Some adjustments to foreign cultures are costly to undertake, but their benefits are only marginal. The expected cost-benefit of any change must be carefully considered.

Resistance to Too Much Change:

Resistance to change may be reduced if only a few demands are made at one time; additional changes may be phased in incrementally.

Participation:

A proposed change should be discussed with stakeholders in advance in order to ease their fears of adverse consequences—and hopefully gain their support.

Reward Sharing

A company may choose to provide benefits for all the stakeholders affected by a proposed change in order to gain support for it.

Opinion Leaders:

Characteristics of opinion leaders often vary by country. By discovering the local channels of influence, an international firm may seek the support of opinion leaders to help speed the acceptance of change.

Timing:

Many good business changes fail because they are ill-timed. Attitudes and needs change slowly, but a crisis may stimulate the acceptance of change.

Learning Abroad:

The essence for undertaking transnational practices is to capitalize on diverse capabilities by transferring learning among all the countries in which a firm operates.

ETHICAL DILEMMAS AND SOCIAL RESPONSIBILITY:**To Intervene or Not to Intervene:**

Neither international firms nor their employees are always expected to adhere to a host government's behavioral norms. Some firms choose not to operate in locales where objectionable social and political practices are the norm; others may operate in such places while pressuring the host country to change; still others may rationalize or simply tolerate the status quo. A difficult question concerns international business practices that may undermine a host country's long-term cultural identity. The Society for Applied Anthropology advises governments and agencies on instituting change in different cultures; its code of ethics considers whether a project or planned change will actually benefit the target population. However, the trade-off between economic gains and the loss of cultural identity and traditions is often very difficult to measure.

DIFFERENCES IN CULTURE

Personal Communication:

Every culture has a communication system to convey thoughts, feelings, knowledge, and information through speech, actions, and writing. Understanding a culture's spoken language provides insight into why people think and behave in a certain way. Understanding a culture's body language avoids unintended or embarrassing messages.

Spoken Language:

1. Spoken Language is the part of a culture's communication system embodied in its spoken and written vocabulary.
2. Linguistically different segments of a population are often culturally, socially, and politically distinct (e.g., Malaysia's population is comprised of Malay [60 percent], Chinese [30 percent], and Indian [10 percent]).
3. Software providers assist companies from English-speaking countries in adapting their Web sites for global e-business. The company that provides customers in Mexico City, Paris, or Tokyo with a quality buying experience in his or her native language will have a competitive edge.
4. Companies have made language blunders in their international business dealings (e.g., When Chevrolet launched its Chevrolet Nova in Spanish-speaking markets, it did not realize that "No va" means "No go" in Spanish).
5. The use of machine translation—software that translates languages—is booming along with the explosion in nonnative English speakers using the Internet (e.g., the French version of "I don't care" ("Je m'en fou") into "I myself in crazy").
6. A lingua franca is a third or "link" language that is understood by two parties who speak different languages (e.g., Sony and Matsushita use English in official company communications—even in non-English-speaking countries).

Body Language:

1. **Body Language** is that which is communicated through unspoken cues, including hand gestures, facial expressions, physical greetings, eye contact, and the manipulation of personal space.
2. **Body language** communicates information and feelings and differs among cultures (e.g., Italians, French, Arabs, and Venezuelans animate conversations with hand gestures). Most body language is subtle and takes time to interpret.
3. **Proximity** is an element of body language; standing too close may invade personal space and appear aggressive (e.g., Middle Eastern cultures stand about 8 to 12 inches apart).

Education:

Education is crucial for passing on traditions, customs, and values. Cultures educate young people through schooling, parenting, religious teachings, and group memberships. Families and other groups provide informal instruction about customs and how to socialize with others.

1. Education Level:

- a. Nations with excellent basic education attract high-wage industries that invest in training and increases productivity. Nations with skilled, well-educated workforces attract high-paying jobs whereas those with poorly educated populations attract low-paying manufacturing jobs.
- b. Newly industrialized economies in Asia owe much of their economic development to solid education systems (e.g., Hong Kong, South Korea, Singapore, and Taiwan focus on mathematical training).

2. The “Brain Drain” Phenomenon:

- a. Brain drain is the departure of highly educated people from one profession, geographic region, or nation to another.
- b. The brain drain in Indonesia is among those that are Western-educated professionals in finance and technology). Eastern Europe experienced high levels of brain drain during the transition to a market economy.
- c. Some countries lure professionals back to their homelands—a process known as reverse brain drain.

Hofstede Framework:

The Hofstede Framework grew from a study of more than 110,000 people working in IBM subsidiaries by Dutch psychologist Geert Hofstede. He developed four dimensions for examining cultures.

1. Individualism versus Collectivism:

This dimension identifies the extent to which a culture emphasizes the individual versus the group.

- a. Individualist cultures value hard work, entrepreneurial risk-taking, and freedom to focus on personal goals.
- b. Collectivist cultures feel a strong association to groups, including family and work units. The goal is to maintain group harmony and work toward collective rather than personal goals.

2. Power Distance:

This dimension identifies the degree to which a culture accepts social inequality among its people.

- a. A culture with large power distance is characterized by inequality between superiors and subordinates. Organizations are hierarchical, with power derived from prestige, force, and inheritance.
- b. Cultures with small power distance display equality, with prestige and rewards equally shared between superiors and subordinates. Power in these cultures derives from hard work and is considered more legitimate.
- c. Refer to Figure 2.4. There is a tight grouping of nations within the five clusters (plus Costa Rica): African, Asian, Central and South American, and Middle Eastern nations in Quadrant 1 (cultures with large power distance and lower individualism). Quadrants 2 and 3 include Australia and the nations of North America and Western Europe (cultures high in individualism and smaller power distance scores).

3. Uncertainty Avoidance:

This dimension identifies the extent to which a culture avoids uncertainty and ambiguity.

- a. Cultures with large uncertainty avoidance value security and place faith in strong systems of rules and procedures in society. They tend to have lower employee turnover, formal rules for employee behavior, and more difficulty implementing change.
- b. Cultures, low on uncertainty avoidance, are more open to change and new ideas.
- c. Refer to Figure 2.5. Quadrant 4 contains nations characterized by small uncertainty avoidance and small power distance, including Australia, Canada, Jamaica, the United States, and many Western European nations. Quadrant 2 contains many Asian, Central American, South American, and Middle Eastern nations—nations having large power distance and large uncertainty avoidance indexes.

4. Achievement versus Nurturing:

This dimension identifies the extent to which a culture emphasizes personal achievement and materialism versus relationships and quality of life.

- a. Cultures scoring high are characterized by assertiveness and the accumulation of wealth, and entrepreneurial drive.
- b. Cultures scoring low have relaxed lifestyles, with more of a concern for others than material gain.

Culture and the Workplace:

1. For an international business with operations in different countries, it is important to understand how a society's culture impacts on the values found in the workplace. The opening and closing cases both provide examples of culture affecting the workplace.
2. Hofstede made a study of IBM employees worldwide, and identified four dimensions that summarize different cultures: power distance, individualism vs. collectivism, uncertainty avoidance, and masculinity vs. femininity. Table 3.1 shows some of the findings of his study and can be used to discuss sets of countries, outliers, and differences between the primary country of the students and other countries. While critics have concerns about Hofstede's methodology, and it is important to caution students from taking it all too seriously, the study does suggest what individuals should consider when doing business from individuals from another country.

Cultural Change:

1. Culture is not a constant, but does evolve over time. What was acceptable behavior in the US in the 1960s is now considered "insensitive" or even harassment. Language and sensuality that was not allowed on American TV in the 1960s is now commonplace. Changes are taking place all the time, as the Management Focus on Matsushita and Japan suggests.
2. As countries become economically stronger and increase in the globalization of products bought and sold, cultural change is particularly common.

Implications for Business:

1. Individuals and firms must develop cross-cultural literacy. International businesses that are ill informed about the practices of another culture are unlikely to succeed in that culture. One way to develop cross-cultural literacy is to regularly rotate and transfer people internationally.
2. One must also beware of ethnocentric behavior, or a belief in the superiority of one's own culture. Perhaps in our presentation of this material we are guilty of this, and have been unable to find some of the obvious weaknesses in US culture and strengths of other cultures. Some students are unaware of the uniqueness of their American culture and are hard pressed to identify American cultural peculiarities. One good lead-in for a discussion on the uniqueness of American culture is to point out that the second free cup of coffee, so common in American restaurants, is unheard of in many European or Asian countries. Students who have traveled internationally can often identify many other examples.
3. Cultural values can influence the costs of doing business in different countries, and ultimately the competitive advantage of the country. The text suggests some positive and negative aspects of US and Japanese culture that may have contributed to the economic success of these countries. Understanding what countries may have a competitive advantage has implications both for looking for potential competitors in world markets and deciding where to undertake international expansion.

Unit 5

INTERNATIONAL TRADE THEORY**Learning Objectives:**

1. Outline and critically evaluate the major theories that attempt to explain 1) why nations should engage in international trade and 2) the patterns of international trade.
2. Show, via simple examples, the case for free trade and how all countries can benefit from free trade.
3. Suggest the conditions under which governments should consider adopting policies that can influence an industry's competitiveness and/or the flow of trade.
4. Describe how each of the theories presented certainly has some validity and seems logical, how in many ways the theories build on each other, and how taken together they explain a great deal of the world trade picture. Yet there is still a great deal more to understand.

Lecture Outlines:

THE GAINS FROM TRADE - GHANA AND SOUTH KOREA

INTRODUCTION

AN OVERVIEW OF TRADE THEORY

Benefits of Trade

Country Focus: Crawfish Wars

Pattern of International Trade

Trade Theory and Government Policy

MERCANTILISM

ABSOLUTE ADVANTAGE

COMPARATIVE ADVANTAGE

The Gains From Trade

Qualifications and Assumptions

Simple Extension of the Ricardian Model

Management Focus: Free Trade and REI

HECKSCHER-OHLIN THEORY

The Leontief Paradox

THE PRODUCT LIFE CYCLE THEORY

Evaluating the Product Life Cycle Theory

THE NEW TRADE THEORY

NATIONAL COMPETITIVE ADVANTAGE: PORTER'S DIAMOND

Factor Endowments

Demand Conditions

Related and Supporting Industries

Firm Strategy, Structure, and Rivalry

Management Focus: The Rise of Finland's Nokia

Evaluating Porter's Theory

IMPLICATIONS FOR BUSINESS

CHAPTER SUMMARY

CRITICAL DISCUSSION QUESTIONS

THE RISE OF THE INDIAN SOFTWARE INDUSTRY

INTERNATIONAL TRADE THEORY

LOOKING TO THE FUTURE:

Companies Watch the Free Trade Trend, Hoping it will continue

Firms that operate internationally tend to benefit from freer trade. Shipments among subsidiaries and access to foreign markets are made easier the more countries adopt free trade policies. There are many indications that the current trend is toward freer trade; however, there are also some difficult issues ahead. Freer trade tends to erode national sovereignty. The benefits of free trade may be unequally distributed between developed and less developed economies. Such issues may have an impact on the progress toward freer trade.

Introduction and Overview of Trade Theory:

1. The opening case comparing Ghana and South Korea illustrates how South Korea's policy of encouraging trade fueled its economic growth, while Ghana's policies resulted in a reallocation of resources away from their most productive uses. It is important that students acknowledge the obvious: these two countries were almost the same. The only apparent difference was their approach to free trade.
2. This chapter reviews a number of different theories of international trade to show why it is beneficial for a country to engage in trade and what patterns of international trade might be expected. You may use Iceland for an example, and pose the question: "What would life be like on Iceland if it did not trade?" Clearly there would be few if any autos or electronic products, and the diet would consist mainly of fish - very inexpensive fish. While it would clearly be technically possible for Iceland to make greenhouses, use heat from its abundant geothermal resources, and supply artificial light to produce all sorts of tropical fruits, these would be very expensive fruit. Thus, it makes sense for Iceland to trade some its abundant fish for other goods produced at lower costs in the rest of the world.
3. While it is easy to see why it makes sense to trade for goods that a country cannot easily produce, it is sometimes harder to understand why a country should not make goods that it can easily produce. There is little reason why the USA should not be able to produce all the sneakers and jeans demanded by its citizens. All of the raw materials required for these goods are available in the USA, as is labor. Nevertheless, the USA imports most of the sneakers and jeans consumed. This is because production is fairly labor intensive, and American labor is much more costly than labor in other parts of the world. American consumers would have to pay a great deal more for these goods if they were made only domestically. Thus, it is beneficial for consumers to purchase goods from their least expensive source, and better that labor produce goods that take advantage of the educational level of most American workers.
4. Having completely free trade is certain to hurt some domestic industries that are not competitive on a worldwide basis. Workers in the textile industry do not like losing their jobs to workers in

other countries who are willing to work for lower wages. This will be looked at in more detail in Chapter 5. Yet consumers want to purchase goods with the best price/quality tradeoff.

5. Some patterns of trade are fairly easy to explain - it is obvious why Saudi Arabia exports oil, the US exports agricultural products, and Mexico exports labor intensive goods. Yet others are not so obvious or easily explained. The US ships Jeep Cherokees to Scandinavia, and Scandinavia ships Volvo station wagons to the US. Clearly it would be technically possible for Scandinavian firms to produce Jeeps and American firms to produce high quality station wagons.
6. You may want some recent examples regarding trade issues in the news. As I write this, the USA and the EU are involved in trade disputes over bananas and beef. (The banana dispute revolves around the EU providing preferential treatment to former colonies.) There always seem to be election campaigns with rhetoric on “protecting jobs” or industries, and the steel unions are considering public demonstrations against steel dumping in the US. Recently, Bethlehem Steel has just sought bankruptcy protection, citing “unfair” foreign imports as a major reason that it has not been able to be internationally competitive. There is usually some current dispute between the US and Japan, or some posturing going on in the EU regarding its Eastern neighbors or former colonies over trade. This past summer, for the first time in world history, a foreign entity—the EU—prohibited two American companies (General Electric and Honeywell) from merging even after that merger had been approved by all the U.S. governmental agencies. Clearly the sovereignty of American business has become globalize. You may ask the class to keep whatever the current issue is in mind as we look at the trade theories to follow.

OPENING CASE: Sri Lankan Trade:

The case describes the Sri Lankan economy, noting its low per capita income (roughly \$900 per year), high dependence on a few minerals and agricultural products (known as primary products) for its foreign exchange earnings, and high unemployment rate. However, its literacy rate, standards of nutrition, health care, equality of income distribution, and life expectancy are some of the highest among emerging economies. Since its independence, Sri Lanka has looked to international trade to help solve such problems as shortage of foreign exchange, overdependence on tea exports, overdependence on the British market, and insufficient growth of output and employment. To solve these problems Sri Lanka has followed three different trade policies since 1960:

- 1960–1977, import substitution (seeking local production of goods and services that would otherwise be imported)
- 1977–1988, strategic trade policy (government actions to develop specific industries with export potential) along with import substitution
- 1988–present, strategic trade policy, along with openness to imports.

In 1995, the World Trade Organization praised Sri Lanka for trade reforms that opened its markets. During the 1990s, Sri Lanka’s real GDP grew rapidly despite a civil war and heavy military expenditures. Recently, Sri Lanka has targeted information technology as a new growth industry.

INTERNATIONAL TRADE THEORY

Absolute Advantage:

1. Adam Smith argued that countries differed in their ability to produce goods efficiently, and they should specialize in the production of the goods they can produce the most efficiently.
2. If Britain were to specialize in textile production and France in wine production, Smith argued that both Britain and France could consume more textiles and wine than if each only produced for their own consumption. Thus trade is a positive sum game.
3. These gains from trade can be showed graphically by looking again at Ghana and South Korea. Figure 4.1 shows both countries' production possibilities frontiers.
4. Table 4.1 can be used to show how consumers in both countries can be better off with specialization of production and trade.
5. When each country has an absolute advantage in one of the products, it is clear that trade is beneficial. But what if one country has an absolute advantage in both products? Then we should consider the country's comparative advantage.

Comparative advantage:

1. Ricardo showed how it makes sense for a country to specialize in the production of goods in which it simply has a comparative advantage, even if it can produce both more efficiently than the other country.
2. Figure 4.2 shows the production possibilities frontiers for Ghana and South Korea when Ghana has an absolute advantage in both cocoa and rice. Points A & B illustrate possible levels of consumption and production without trade.
3. Ghana has a comparative advantage in the production of cocoa since it can produce 4 times as much cocoa as South Korea, but only 1.5 times as much rice. Ghana is comparatively more efficient at producing cocoa than rice.
4. Points C and K' in Figure 4.2 show a possible new production point for each country. Table 4.2 shows how, with trade, both Ghana and South Korea can increase consumption of both products.
5. This simple example makes a number of assumptions: only two countries and two goods; zero transportation costs; similar prices and values; resources are mobile between goods within countries, but not across countries; constant returns to scale; fixed stocks of resources; and no effects on income distribution within countries. While these are all unrealistic, the general proposition that countries will produce and export those goods that they are the most efficient at producing remains quite valid.
6. Diminishing returns to specialization simply suggest that after some point, the more of a good that a country produces, the greater will be the units of resources required to produce each additional item. If crops are grown on increasingly less fertile land, mining is done on less productive ore regions, or less skilled personnel need to be hired to perform high skilled jobs, production per unit

of input will decrease. Diminishing returns implies a PPF which is convex (as shown in Figure 4.3). In reality countries do not specialize entirely, but produce a range of goods. It is worthwhile to specialize up until that point where the resulting gains from trade are offset by diminishing returns.

7. Opening an economy to trade is likely to generate dynamic gains of two types. First, trade might increase a country's stock of resources as increased supplies become available from abroad. Secondly, free trade might increase the efficiency of resource utilization, and free up resources for other uses. Figure 4.4 shows how dynamic gains can shift a country's PPF outwards.

Heckscher-Ohlin Theory:

1. The Heckscher-Ohlin theory predicts that countries will export those goods that make intensive use of factors of production that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. Thus it focuses on differences in relative factor endowments rather than differences in relative productivity.
2. When we look at US agricultural exports (abundant fertile land), Icelandic and Norwegian fish exports (coastal waters climates conducive to good fish), Canadian lumber exports (plentiful forests with few people), Saudi oil exports, and South African gold exports, the Heckscher-Ohlin theory seems to make sense.
3. Using the Heckscher-Ohlin theory, Leontief postulated that the US should be an exporter of capital intensive goods and an importer of labor intensive goods. To his surprise, however, he found that US imports were less capital intensive than US exports. Hence, while we can see some support for Heckscher-Ohlin, other evidence contradicts it.

The Product Life Cycle Theory:

1. Vernon suggested that as products mature; both the location of sales and the optimal production location will change, affecting the direction and flow of imports and exports. The effects of this theory are illustrated in Figure 4.5.
2. While the product life cycle theory accurately explains what has happened for products like photocopiers and a number of other high technology products developed in the US in the 1960s and 1970s, the increasing globalization and integration of the world economy has made this theory less valid in today's world.

The New Trade Theory:

1. New trade theory suggests that because of economies of scale and increasing returns to specialization, in some industries there are likely to be only a few profitable firms. Thus, firms with first mover advantages will develop economies of scale and create barriers to entry for other firms. The commercial aircraft industry is an excellent example. Boeing, established in the early 1910s, has long had a superior advantage over other aircraft manufacturers that have not had the advantage of governmental subsidies (like Airbus).
2. Productive efficiency may not be the result of factor endowments or specific national characteristics, but instead be a result a firm's first mover advantages.

3. New trade theory does not contradict the theory of comparative advantage, but instead identifies a source of comparative advantage.
4. An obvious and controversial extension of new trade theory is the implication that governments should consider strategic trade policies. Strategic trade policies would suggest that governments should nurture and protect firms and industries where first mover advantages and economies of scale are likely to be important, as doing so can make it more likely that a firm will build economies of scale and eventually end up a winner in the global competitive race.

National Competitive Advantage: Porter's Diamond:

1. Porter's study tried to explain why a nation achieves international success in a particular industry. This study found four broad attributes that promote or impede the creation of competitive advantage. These are shown in Figure 4.6.
2. Factor Endowments: A nation's position in factors of production such as skilled labor or infrastructure necessary to compete in a given industry can be critical. These factors can be either basic (natural resources, climate, location) or advanced (skilled labor, infrastructure, technological know-how). While either can be important, advanced factors are more likely to lead to competitive advantage
3. Demand Conditions: The nature of home demand for the industries product or service influences the development of capabilities. Sophisticated and demanding customers pressure firms to be competitive.
4. Relating and Supporting Industries: The presence in a nation of supplier industries and related industries that are internationally competitive can spill over and contribute to other industries. Successful industries tend to be grouped in clusters in countries - having world class manufacturers of semi-conductor processing equipment can lead to (and be a result of having) a competitive semi-conductor industry.
5. Firm Strategy, Structure, and Rivalry: The conditions in the nation governing how companies are created, organized, and managed, and the nature of domestic rivalry impacts firms' competitiveness. Firms that face strong domestic competition will be better able to face competitors from other international firms.
6. In addition to these four main attributes, government policies and chance can impact any of the four. Government policy can affect demand through product standards, influence rivalry through regulation and antitrust laws, and impact the availability of highly educated workers and advanced transportation infrastructure.
7. The four attributes of the diamond, government policy, and chance work as a reinforcing system, complementing each other and in combination creating the conditions appropriate for competitive advantage. The Management Focus on Nokia, provides a good example of how this Finnish firm built its competitive advantage as a result of factors in Porter's diamond.

8. Like the other theories we have studied in this chapter, the diamond makes sense in some situations. There is also anecdotal evidence of its applicability in certain situations. Yet some forms of trade are much more simply explained by simple absolute advantage (Saudi Arabia's oil exports). And this or any theory does not easily explain other trade patterns.

Implications for Business:

1. Most of the theories discussed have implications for the location of production activities. Firms will attempt to locate different activities in the location that is optimal for the production of that good, component, or service.
2. Being a first mover can have important competitive implications, especially if there are economies of scale and the global industry will only support a few competitors. Firms need to be prepared to undertake huge investments and suffer losses for several years in order to reap the eventual rewards.
3. Governmental policies with respect to free trade or protecting domestic industries can significantly impact global competitiveness. The opening case showed how Ghana's policies negatively impacted the global success of its cocoa business. While new trade theory may suggest that governments subsidize specific industries, Porter's theory focuses how policies can influence the attributes of the diamond.
4. One of the most important implications for business is that they should work to encourage governmental policies that support free trade. If a business is able to get its goods from the best sources worldwide, and compete in the sale of products into the most competitive markets, it has a good chance to survive and prosper. If such openness is restricted, a business's long-term survival will be in greater question.

INTERNATIONAL TRADE THEORY

ABSOLUTE ADVANTAGE:

In 1776, Adam Smith questioned the prevailing Mercantilist ideas on trade and developed the theory of Absolute Advantage. Smith reasoned that if trade were unrestricted, each country would specialize in those products in which it had a competitive advantage. Each country's resources would shift to the efficient industries because the country could not compete in the inefficient ones. Through specialization, countries could improve their efficiency because 1) labor could become more skilled by repeating the same tasks, 2) labor would not lose time in switching among production of different products, and 3) long production runs would provide incentives for the development of more efficient working methods.

Natural Advantage:

A country may have a natural advantage in some products because of climate or other natural resources (labor, minerals, etc.).

Acquired Advantage:

In manufactured goods, countries usually have acquired an advantage in either their product or process technology.

Resource Efficiency Example:

Figure 5.2 illustrates how the United States has an absolute advantage in wheat, while Sri Lanka has an absolute advantage in tea. By the U.S. specializing in wheat production and Sri Lanka specializing in tea production, the global production of tea and wheat can be increased.

COMPARATIVE ADVANTAGE:

Would there still be benefits to be gained from trade if a single country were more efficient at both products (i.e., the same country had an absolute advantage in both products)? In 1817, David Ricardo examined this question and found that, yes, trade was still beneficial even when the same country was better at producing both goods.

A. An Analogous Explanation of Comparative Advantage:

Assume the best physician in town is also the best medical secretary. Should he try to do both tasks? No, if the physician wants to maximize his/her income, s/he should work as a physician and hire someone else to serve as medical secretary. The same kind of logic applies to the theory of comparative advantage.

B. Production Possibility Example:

See Figure 5.3 in the text. The illustration is altered (from Figure 5.2) to where the United States now is more efficient than Sri Lanka in both wheat production and tea production. However, the United States has a comparative advantage in wheat production (over tea production). Therefore, by concentrating on the product where it has its greatest efficiency advantage (wheat) and letting Sri Lanka produce the product (tea) in which the United States is comparatively less efficient, global output can be increased and specialization and trade can benefit both countries.

SOME ASSUMPTIONS AND LIMITATION OF THE THEORIES OF SPECIALIZATION:**A. Full Employment:**

These theories assume full employment. Let's say that the physician above had free time on his hands (less than full employment). It might then be in his/her best interest to do the medical secretary tasks as well.

B. Economic Efficiency Objective:

In the physician example, it was assumed that profit maximization was the physician's goal. That may not be the case. Perhaps the physician enjoyed doing administrative tasks. In the same way, countries often pursue objectives other than output efficiency.

C. Division of Gains:

While specialization does increase output, it is unclear how the gains from the additional output will be divided. Trade will benefit both countries, but it usually does not benefit both countries equally. If one country perceives a trading partner as receiving too large a share of the benefits, that country may forgo its relatively small absolute gains in order to prevent the other country from receiving large gains.

D. Two Countries, Two Commodities:

The world is comprised of multiple countries and multiple commodities. Although the assumption of two countries and two commodities is unrealistic, it does not diminish the theories' usefulness. Economists have applied the same reasoning and demonstrated economic efficiency advantages in multiproduct and multicountry trade relationships.

E. Transport Costs:

If it costs more to transport the goods than is saved through specialization, then the advantages of trade are negated.

F. Mobility:

The theories of absolute and comparative advantage assume that resources can move domestically from the production of one good to another, and at no cost. This is often not correct. For example, a steelworker in Indiana might not move easily into a software development job in California.

G. Services:

Though the theories discussed above deal with commodities, much of the reasoning can be applied to trade in services as well since, like commodities, the production of services consumes resources.

THEORY OF COUNTRY SIZE:

Absolute and comparative advantage theories do not consider the impact of country size on trade patterns. This is discussed ahead.

A. Variety of Resources:

Large countries are apt to have greater variety in climate and natural resources, making them more self-sufficient than smaller countries.

B. Transport Costs:

Large countries tend to face larger transportation costs in serving their markets domestically. It may be cheaper to buy imports simply if you live near the border than to have domestically produced cheaper goods shipped from across the country.

C. Size of Economy and Production Scales:

For products that can be produced more efficiently en masse, small countries will tend to export more, while large countries may be able to achieve economies of scale simply by producing for their domestic market.

FACTOR PROPORTIONS THEORY:

Heckscher and Ohlin helped predict the types of products in which countries would possess a comparative advantage. They predicted that countries would tend to export products that utilized factors of production which were relatively abundant in their country.

A. Land-Labor Relationship:

In countries with a lot of labor relative to the amount of land, labor (abundant) would be relatively cheaper than land (scarce). The country would then concentrate on the production of labor-intensive goods, since it could produce those goods more cheaply than could a country where labor was relatively scarce (and therefore more expensive).

B. Labor-Capital Relationship:

In countries where there is little capital (scarce) available for investment and where the amount of investment per worker is low, one would expect labor rates to be low and export competitiveness to occur in goods requiring large amounts of labor relative to capital.

C. Technological Complexities:

The factor-proportions analysis becomes more complicated when the same product can be produced by different methods, such as with labor or capital. In the final analysis, managers must compare the cost in each locale based on the type of production that will minimize costs there.

THE PRODUCT LIFE CYCLE THEORY OF TRADE:

Ray Vernon's theory tries to explain why the production and consumption locations of goods change in predictable patterns over time.

Stage 1: Introduction:

New products tend to be produced in and consumed in high-income industrial countries.

- **Innovation, production, and sales in same country:** New products tend to be developed near the market for these products. This domestic production ensures rapid feedback from the market.
- **Location and importance of technology:** Industrialized countries tend to be the location preferences for R&D investment. Consequently, technological innovations tend to occur in industrialized countries.
- **Exports and labor:** In stage one, production tends to be more labor-intensive. Process technology has not been automated and product technology is still in flux.

Stage 2: Growth:

As demand grows, the producer may be led to establish foreign production facilities in order to tap additional markets. Competitors in other developed countries might also begin production.

Stage 3: Maturity:

Worldwide demand begins to level off. Because markets and technologies are widespread, the innovating country no longer has a production advantage. There are incentives to move plants to emerging markets where unskilled, inexpensive labor is sufficient for standardized production processes.

Stage 4: Decline:

By this time, market and cost factors have led to almost all production occurring in emerging markets. Replacement units tend to now be exported from LDCs to the country where the innovation was first developed.

Verification and Limitations of the PLC Theory:

There are a number of exceptions to the PLC theory, such as products with very short life cycles, luxury products, products that require highly skilled labor, and products that never take on commodity-like characteristics.

COUNTRY SIMILARITY THEORY:**A. Economic Similarity of Industrial Countries:**

Most of the world's trade occurs among countries that have similar characteristics (e.g., developed countries with other developed countries). Similar markets will have demand for similar products.

B. Similarity of Location:

Countries that are near each other will trade more than countries that are distant from each other. Transportation costs are only one of several facts explaining these patterns.

C. Cultural Similarity:

Having a similar language and religion tends to facilitate trade among countries.

D. Similarity of Political and Economic Interests:

Cuba and the United States, which have very dissimilar political and economic interests, don't trade. Countries that see eye-to-eye politically and economically tend to have stronger trade relationships than those who do not.

DEGREE OF DEPENDENCE:

No country is entirely independent from or entirely dependent on other countries. Rather, countries can be placed on a continuum between those two extremes.

A. Independence:

In this instance, a country would have no reliance on other countries for any goods, service, or technologies. Of course, such a country would have to go without any goods they could not produce themselves. Certain indigenous tribes cut off from the rest of the world would serve as examples of extreme independence.

B. Interdependence:

In this instance, countries develop trade relationships based on mutual need. France and Germany, for example, have highly interdependent economies. Each depends about equally on the other as a trading partner, and so neither is likely to cut off supplies or markets for fear of retaliation.

C. Dependence:

Many developing countries have decried their dependence because they rely so heavily on the sale of one primary commodity and/or on one country as a customer and supplier. This dependence often has grown out of a colonial relationship. Roughly one-fourth of emerging economies depend on one country for more than half of their export earnings.

STRATEGIC TRADE POLICY:

If an acquired advantage can give a country a competitive advantage in trade, it is natural that governments would be interested in developing acquired advantages in their country. How can governments help create successful industries within their borders? Two approaches are: 1) alter conditions that will affect industry in general; and 2) alter conditions that will affect a targeted industry.

Implications for Business:

1. Most of the theories discussed have implications for the location of production activities. Firms will attempt to locate different activities in the location that is optimal for the production of that good, component, or service.
2. Being a first mover can have important competitive implications, especially if there are economies of scale and the global industry will only support a few competitors. Firms need to be prepared to undertake huge investments and suffer losses for several years in order to reap the eventual rewards.
3. Governmental policies with respect to free trade or protecting domestic industries can significantly impact global competitiveness. The opening case showed how Ghana's policies negatively impacted the global success of its cocoa business. While new trade theory may suggest that governments subsidize specific industries, Porter's theory focuses how policies can influence the attributes of the diamond.
4. One of the most important implications for business is that they should work to encourage governmental policies that support free trade. If a business is able to get its goods from the best sources worldwide, and compete in the sale of products into the most competitive markets, it has a good chance to survive and prosper. If such openness is restricted, a business's long-term survival will be in greater question.

INTERNATIONAL TRADE THEORY

Factor Proportions Theory:

Factor proportions theory states that countries produce and export goods that require resources (factors) that are abundant (and thus cheapest) and import goods that require resources in short supply. Thus, the theory focuses on the productivity of the production process.

Labor versus Land and Capital Equipment:

- a. Factor proportions theory breaks resources into two categories: 1) labor and 2) land and capital equipment. It predicts that a country will specialize in products that require labor if the cost of labor is low relative to the cost of land and capital, and vice versa.
- b. Factor proportions theory is conceptually appealing (e.g., Australia has much land and a small population; its exports consist of products that require much land while imports consist of manufactured and consumer goods).

Evidence on Factor Proportions Theory: The Leontief Paradox:

- a. Factor proportions theory is not supported by studies that examine trade flows.
- b. Wassily Leontief tested whether the U.S., which uses an abundance of capital equipment, exports goods requiring capital-intensive production and imports goods requiring labor-intensive production. His research found that U.S. exports require more labor-intensive production than its imports. This apparent paradox is called the Leontief paradox.
- c. One explanation is that factor proportions theory considers a country's production factors to be homogeneous—particularly labor. But labor skills vary greatly within a country.

International Product Life Cycle:

The international product life cycle theory says that a company will begin by exporting its product and later undertake foreign direct investment as the product moves through its life cycle. As a result, a country's export eventually becomes its import.

Stages of the Product Life Cycle:

- a. In new product stage, stage 1, the high purchasing power and demand of spur a company to design and introduce a new product concept (see Figure 5.6). Although initially there is virtually no export market, exports increase late in the new product stage.
- b. In the maturing product stage, stage 2, the domestic market and markets abroad become fully aware of the existence of the product and its benefits. Demand rises and is sustained over a fairly lengthy period of time. Near the end of the maturity stage, the product generates sales in developing nations, and manufacturing is established there.
- c. In the standardized product stage, stage 3, competition from other companies selling similar products pressures companies to lower prices in order to maintain sales levels. An aggressive search for low-cost production bases abroad begins and the home market may begin importing.

Limitations of the Theory:

- a. The United States is no longer the sole innovator of products in the world; new products spring up everywhere as the research and development activities globalize.
- b. Companies today design new products and make product modifications at a very quick pace.
- c. Companies introduce products in many markets simultaneously to recoup a product's research and development costs before sales decline.
- d. The theory is challenged by the fact that more companies are operating in international markets from their inception. The Internet has made this easier particularly for small and midsize companies. Also, small companies are more often teaming up with companies in other markets to develop new products or production technologies.
- e. Yet, the international product life cycle theory retains explanatory power when applied to technology-based products that are eventually mass-produced.

New Trade Theory:

The new trade theory argues that 1) there are gains to be had from specialization and increasing economies of scale, 2) those companies first to market can create barriers to entry, and 3) government may have a role to play in assisting its home-based companies. The theory emphasizes productivity rather than resources.

First-Mover Advantage:

- a. As specialization and output increase, companies realize economies of scale, and unit production costs decline. Then companies expand, lower prices, and force competitors to produce at a similar level of output to be competitive.
- b. A first-mover advantage is the economic and strategic advantage gained by being the first company to enter an industry. It creates a barrier to entry for potential rivals and may allow a country to dominate in a product.
- c. Some make a case for government assistance; by working together to target new industries, a government and its home-based companies can be the first mover in an industry.

INTERNATIONAL TRADE THEORY

THE FACTOR-PROPORTIONS THEORY:

The Heckscher-Ohlin theory of factor endowment is useful in extending the concept of comparative advantage by bringing into consideration a nation's endowment and cost of factors of production. The theory holds that a country will tend to export products that utilize factors of production relatively abundant in that nation.

Land-Labor Relationship:

In countries with many people relative to the size of the available land, labor would be relatively (comparatively) cheap; thus those countries should concentrate on producing and exporting labor-intensive goods.

Labor-Capital Relationship:

In countries where little capital is available for investment and where the amount of investment per worker is low, then low labor rates would also be expected. Again, those countries should concentrate on producing and exporting labor-intensive goods. (The fact that labor skills tend to vary across countries has led to international task specialization with respect to national production activities.)

Technological Complexities:

Factor proportions analysis becomes complicated when the same product can be produced by different methods, such as with different mixes of labor and capital. Managers must consider the cost in each locale, based on the type of production that will minimize costs there.

THE PRODUCT LIFE CYCLE THEORY OF TRADE:

Vernon's international product life cycle (PLC) describes how the location of production and trade activities shifts as a product moves through its life cycle.

Changes through the Cycle:

A great majority of the new technology that results in new products and production methods originates in industrial countries.

- **Introduction:** Innovation, production and sales occur in the domestic (innovating) country. Because the product is not yet standardized, the production process tends to be relatively labor intensive, and innovative customers tend to accept relatively high introductory prices.
- **Growth:** As demand grows, competitors enter the market. Foreign demand, competition, exports and often direct investment activities also begin to accelerate.
- **Maturity:** Global demand begins to peak, production processes are relatively standardized and global price competition forces production site relocation to lower cost developing countries.
- **Decline:** Market factors and cost pressures dictate that almost all production occur in developing countries. The product is then imported by the country where it was initially developed.

Verification and Limitations of the PLC Theory:

Exceptions to the typical pattern of the international product life cycle would include: products that have very short life cycles, luxury goods, products that require specialized labor, products that can be differentiated and products for which transportation costs are relatively high.

COUNTRY SIMILARITY THEORY:

Previously examined theories would lead one to conclude that the greater the dissimilarity among countries, the greater the potential for trade. However, the country similarity theory states that when a firm develops a new product in response to observed conditions in the home market, it is likely to turn to those foreign markets that are most similar to its domestic market when commencing its initial international expansion activities.

The Economic Similarity of Industrial Countries:

So much trade takes place among industrialized countries because of the growing importance of acquired advantage (skills and technology). In addition, markets in most industrialized countries are large enough to support new product introductions and their subsequent variants across the life cycle.

The Similarity of Location:

Countries that are near to each other enjoy relatively lower transportation costs than those that are more distant. While the disadvantages of distance may be overcome through innovative technology and marketing methods, such gains are difficult to maintain in the long run.

Cultural Similarity:

Cultural similarity as expressed through language and religion is a major facilitator of the international trade and investment process.

The Similarity of Political and Economic Interests:

Countries that agree politically and are economically similar are likely to encourage trade among themselves. In some circumstances at least, they may also discourage trade among countries with whom they disagree.

DEGREE OF DEPENDENCE:

Theories of independence, interdependence and dependence help explain world trade patterns and countries' trade policies. Realistically, countries are located along a continuum between the two extremes.

Independence:

Under conditions of independence, a country would not rely on other countries for any goods, services, or technologies.

Interdependence:

One way a country can limit its vulnerability to foreign changes is through interdependence, i.e., the development of trade relationships on the basis of mutual need. Each country depends about equally on the other as a trading partner, so neither is likely to cut off supplies or markets for fear of retaliation from the partner nation.

Dependence:

Many developing countries are dependent (rely on) on the sale of one primary commodity, or on one country as a primary customer and/or supplier. In addition, emerging economies largely depend on production processes that compete on the basis of low-wage inputs.

STRATEGIC TRADE POLICY:

Governments have long debated their roles in affecting the acquired advantage of production within their borders. From the standpoint of national competitiveness, the issue revolves around the development of successful industries. The two basic approaches to strategic trade policy are (a) alter conditions that will affect industry in general or (b) alter conditions that will affect a targeted industry.

WHY COMPANIES TRADE INTERNATIONALLY:

Regardless of the advantages a country may gain by trading, international trade will not ordinarily occur unless companies within that country have competitive advantages and perceive that international opportunities are greater than domestic ones.

The Porter Diamond:

In addition to the four determinants of national competitive advantage that are set forth in the Porter diamond, the roles of chance and government are also critical. Usually all four determinants need to be favorable if a given national industry is going to attain global competitiveness.

- **Demand Conditions:** The nature and size of demand in the home market lead to the establishment of production facilities to meet that demand.
- **Factor Conditions:** Resource availability (inputs, labor, capital and technology) contributes to the competitiveness of both firms and nations that compete in particular industries.
- **Related and Supporting Industries:** The local presence of internationally competitive suppliers and other related industries contributes to both the cost effectiveness and strategic competitiveness of firms.
- **Firm Strategy, Structure and Rivalry:** The creation and persistence of national competitive advantage requires leading-edge product and process technologies and business strategies.

Points and Limitations of the Porter Diamond:

The existence of the four favorable conditions often represents a necessary but not a sufficient condition for the development of a particular national industry. Even when abundant, resources are ultimately limited, thus firms must make choices regarding their pursuit of existing opportunities. Further, given the ability of firms to gain market information and production inputs from abroad, the absence of any of the four conditions within a country may be overcome by their existence internationally.

Governments have long debated their roles in affecting the acquired advantage of production within their borders. From the standpoint of national competitiveness, the issue revolves around the development of successful industries. The two basic approaches to *strategic trade policy* are (a) alter conditions that will affect industry in general or (b) alter conditions that will affect a targeted industry.

INTERNATIONAL TRADE THEORY

The Case for Government Intervention:

1. The most common political reason for trade restrictions is "protecting jobs and industries." Usually this results from political pressures by unions or industries that are "threatened" by more efficient foreign producers, and have more political clout than the consumers that will eventually pay the costs.
2. Keeping industries "vital for national security" viable is an oft used argument for trade restrictions. While this is reasonable for industries like steel, aerospace, and electronics, in the US the shoe industry has regularly lobbied that soldiers need boots, and thus the US needs to have a viable shoe industry in order to be able to provide shoes during a time of war.
3. Government intervention in trade can be used as part of a "get tough" policy to open foreign markets. By taking, or threatening to take, specific actions, other countries may remove trade barriers. But when threatened governments don't back down, tensions can escalate and new trade barriers may be enacted.
4. Consumer protection can also be an argument for restricting imports. The opening case suggests that the EU's concern over bananas was, in part, due to an interest in protecting consumers. Since different countries do have different health and safety standards, what may be acceptable in one country, may be unacceptable in others.
5. Concern over human rights in other countries plays an important role in foreign policy. Governments sometimes use trade policy to improve the human rights policies of trading partners. Governments also use trade policies to put pressure on governments to make other changes. In recent years the USA has had trade restrictions against Libya, Iran, Iraq, North Korea, Cuba, and other countries whose governments were pursuing policies that were not viewed favorably by the US government. Unless a large number of countries choose to take such action, however, it is unlikely to prove successful.
6. The "infant industry" argument suggests that an industry should be protected until it can develop and be viable and competitive internationally. Unless an industry is allowed to develop and achieve minimal economies of scale, foreign competitors may undercut prices and prevent a domestic industry from developing. The infant industry argument has been accepted as a justification for temporary trade restrictions under the WTO.
7. A problem with the infant industry argument is determining when an industry "grows up." Some industries that are just plain inefficient and uncompetitive have argued they are still infants after 50 years. The other problem is that given the existence of global capital markets, if the country has the potential to develop a viable competitive position, its firms should be capable of raising the necessary funds without additional support from the government.

8. Strategic trade policy suggests that in cases where there may be important first mover advantages, governments can help firms from their countries attain these advantages.
9. Strategic trade policy also suggests that governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage.

The Revised Case for Free Trade:

1. While strategic trade policy identifies conditions where restrictions on trade may provide economic benefits, there are two problems that may make restrictions inappropriate: retaliation and politics.
2. Intervening to aid domestic firms will only be successful if other countries do not take similar actions that offset the effects.
3. While it could be very difficult to identify situations where strategic intervention in trade is economically appropriate, various interest groups will be certain to lobby that particular firms should be aided. Given the ease with which special interest groups seem to be able to capture the attention of the government, it is more likely that consumers will be harmed more needlessly than producers. It is unreasonable to expect the government to be completely fair and objective in “targeting” industries, when different industries, lobbies, and politicians all have their own objectives for “getting their paws in the honey pot” of governmental funds.

The Development of the World Trading System:

1. Up until the Great Depression of the 1930s, most countries had some degree of protectionism. Great Britain, as a major trading nation, was one of the strongest supporters of free trade.
2. Although the world was already in a depression, in 1930 the US enacted the Smoot-Hawley tariff, which created significant import tariffs on foreign goods. As other nations took similar steps and the depression deepened, world trade fell further.
3. After WWII, the US and other nations realized the value of freer trade, and established the General Agreement on Tariffs and Trade (GATT). [Referred to sometimes as the General Agreement to Talk and Talk.]
4. The approach of GATT was to gradually eliminate barriers to trade. Over 100 countries became members of GATT, and worked together to further liberalize trade. Figure 5.1 shows the different rounds of GATT negotiations and the resulting reductions in tariffs.
5. During the 1980s and early 1990s the world trading system as “managed” by GATT underwent strains. First, Japan’s economic strength and huge trade surplus stressed what had been more equal trading patterns, and Japan’s perceived protectionist (neo-mercantilist) policies created intense political pressures in other countries. Second, the persistent trade deficits by the US, the world’s largest economy, caused significant economic problems for some industries and political problems for the government. Thirdly, many countries found that although limited by GATT from utilizing tariffs, there were many other more subtle forms of intervention that had the same effects and did not technically violate GATT (e.g. VERs).

6. Against the background of rising protectionist pressures, in 1986 GATT members embarked on their eighth round of negotiations to reduce tariffs (called the Uruguay Round). This was the most ambitious round to date, as the goal was to expand beyond the regulation of manufactured goods and address trade issues related to intellectual property, agriculture, services, and enforcement mechanism. Table 5.1 illustrates the main features of the agreement that was finally reached in 1993.
7. The agreement, however, left several important matters unaddressed: financial services, broadcast entertainment, environmental matters, worker's rights, and foreign direct investment. Those items were left to further negotiations under the auspices of the World Trade Organization.
8. When the WTO was established, its creators hoped the WTO's enforcement mechanisms would make it a more effective policeman of the global trade rules than the GATT had been. The WTO has handed down a number of rulings that have led to changes in governmental policies that restricted trade; in other cases governments had made changes in advance of WTO rulings.
9. Under the WTO, 68 countries that account for more than 90% of world telecommunications revenues pledged to open their markets to foreign competition and to abide by common rules for fair competition in telecommunications. The WTO has also made headway in liberalizing trade in financial services, although the current agreement still includes a number of exceptions.
10. Substantial work still remains to be done on the international trade front. Environmental policies are one area of concern, as are regulations regarding foreign direct investment.

Implications for Business:

1. Clearly, trade barriers negatively impact the ability of firms to locate activities in the economically optimal location or source materials from the best producers. Trade barriers can change the underlying costs and benefits of different locations, and force firms to undertake operations in specific locations rather than import or export.
2. Even if specific quotas, tariffs, local content, etc. regulations do not specifically require that certain actions be taken, a firm may choose to locate facilities or buy from certain suppliers in order to reduce the threat of mandatory and more punitive governmental intervention.
3. Certain trade barriers may even make some operations no longer viable, and force a firm to give up particular markets or production sites.
4. In general international firms have an incentive to lobby for free trade, and keep protectionist pressures from causing them to have to change strategies. While there may be short-term benefits to having governmental protection in some situations, in the long run these can back fire and other governments can retaliate.

Unit 6**THE POLITICAL ECONOMY OF INTERNATIONAL TRADE****Learning Objectives**

1. Outline and critically evaluate the major theories that attempt to explain 1) why nations should engage in international trade and 2) the patterns of international trade.
2. Show, via simple examples, the case for free trade and how all countries can benefit from free trade.
3. Suggest the conditions under which governments should consider adopting policies that can influence an industry's competitiveness and/or the flow of trade.
4. Describe how each of the theories presented certainly has some validity and seems logical, how in many ways the theories build on each other, and how taken together they explain a great deal of the world trade picture. Yet there is still a great deal more to understand.

Lesson Outlines

THE GAINS FROM TRADE - GHANA AND SOUTH KOREA

INTRODUCTION

AN OVERVIEW OF TRADE THEORY

Benefits of Trade

Country Focus: Crawfish Wars

Pattern of International Trade

Trade Theory and Government Policy

MERCANTILISM

ABSOLUTE ADVANTAGE

COMPARATIVE ADVANTAGE

The Gains from Trade

Qualifications and Assumptions

Simple Extension of the Ricardian Model

Management Focus: Free Trade and REI

HECKSCHER-OHLIN THEORY

The Leontief Paradox

THE PRODUCT LIFE CYCLE THEORY

Evaluating the Product Life Cycle Theory

THE NEW TRADE THEORY

NATIONAL COMPETITIVE ADVANTAGE: PORTER'S DIAMOND

THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

THE POLITICAL ENVIRONMENT:

The political environment can have a dramatic impact on the operations of a firm. U.S. managers may be accustomed to a stable political system and a relatively homogenous population. This is often not true in other countries. A political system integrates the parts of a society into a viable, functioning unit. Sometimes that is a very difficult task. A country's political system influences how business is conducted domestically and internationally.

THE IMPACT OF THE POLITICAL SYSTEM ON MANAGEMENT DECISIONS:

Political Risk:

Political risk occurs when there is a possibility that the political climate in a foreign country will change in such a way that the operations of international companies in that country will deteriorate.

- **Types and causes of political risk:** Types of political risk include government takeovers of property, operating restrictions, and agitation that damages the company's performance. Such problems can be caused by changing opinions of political leadership, civil disorder, and changes in external relations (such as animosity between the home and host country governments).
- **Macro and micro political risks:** If political actions are aimed only at specific foreign investments (e.g., a single foreign company), they are considered micro political risks. If they are aimed at a broad spectrum of foreign investors (e.g., when all foreign-owned private property was taken over by Cuba), they are considered macro political risks.

Government Intervention in the Economy:

Some governments adopt an "individualistic paradigm" and keep intervention in the economy at a minimum. Others adopt a "communitarian paradigm" wherein the government plays a larger role in the economy. They thrive on a respected, centralized bureaucracy with a stable political party or coalition in power. If a U.S. firm moves from the United States (individualistic) to Germany, Japan, or South Korea (communitarian), it may have to develop new strategies for its relationships with government, suppliers, customers, and competitors

NONECONOMIC RATIONALES FOR GOVERNMENT INTERVENTION

Maintaining Essential Industries:

Certain industries are deemed essential to the functioning of a country (e.g., the defense industry). Therefore, governments often subsidize and protect domestic manufacturers in these industries. Governments are hesitant to depend on foreign firms for such products, lest they be cut off during war or other political disagreements. However, almost all industries can be considered essential in one way or another.

Dealing with "Unfriendly" Countries:

Groups concerned about security often use defense arguments to prevent exports, even to friendly countries, of strategic goods that might fall into the hands of potential enemies.

Maintaining Spheres of Influence:

Governments often give aid and credits to, and encourage imports from, countries that join a political alliance or vote a certain way with international bodies.

Preserving Cultures and National Identity:

Countries are held together by a common sense of identity. To protect this identity, countries limit foreign products and services in certain sectors. For example, Canada limits foreign publishing, cable TV, and book selling.

INSTRUMENTS OF TRADE CONTROL:**Tariffs:**

A tariff, or duty, is the most common type of trade control. It is a tax governments levy on a good shipped internationally. If collected by the exporting country, it is called an export tariff; if collected by a country through which the good passes, it is a transit tariff; if collected by the importing country, it is an import tariff. Import tariffs (the most common tariffs) serve to raise the price of imported goods so that domestically produced goods will gain a relative price advantage. If a government assesses a tariff on a per-unit basis, it is called a specific duty. If the tariff is assessed as a percentage of the value of the item, it is called an ad valorem duty. If the same product is subject to a specific and an ad valorem duty, the combination is a compound duty.

Nontariff Barriers: Direct Price Influences:

- **Subsidies:** Subsidies are economic benefits provided by the government to exporters, which gives them an unfair advantage in foreign markets. However, there is little agreement on what actually constitutes a subsidy. For example, did Canada subsidize fish exports when it gave fishermen grants to buy trawlers? Did the United Kingdom subsidize steel when the government-owned steel company had severe losses?
- **Aid and loans:** Governments give aid and loans to other countries and require that the funds be spent in the donor country (i.e., tied loans or tied aid). These loans make it possible for certain products to compete abroad that would otherwise be noncompetitive.
- **Customs valuation** Sometimes it is difficult to determine the true value of an import in order to determine the amount of an ad valorem tariff (e.g., the 2,000 bicycles imported to Argentina with an invoice price of \$1.78 each). In such instances, customs officers assess the value of the imported goods—thereby affecting their price.
- **Other direct price influences:** Countries frequently use other means to affect prices, including special fees, customs deposits, and minimum price levels.

Nontariff Barriers: Quantity Controls:

- **Quotas:** The most common type of import or export restriction based on quantity is the quota. A quota most frequently limits the quantity of a product allowed to be imported in a given year. A specific type of quota that prohibits all trade is an embargo (essentially a quota of zero).

- **“Buy local” legislation:** Local content laws fall within this category. There is abundant legislation worldwide that simply prescribes a minimum percentage of domestic value that a given product must have for it to be legally sold within the country. Another form of “buy local” legislation occurs when governments give preferential treatment to domestic producers in their acquisition of goods and services.
- **Standards:** Countries commonly have set classification, labeling, and testing standards in a manner that allows the sale of domestic products but inhibits that of foreign-made ones. For example, U.S. genetically enhanced corn is not permitted in Europe even though there is no evidence that the corn poses any human health risk.
- **Specific permission requirements:** Some countries require that potential importers or exporters secure permission from government authorities before being allowed to conduct trade transactions. The time, effort, and expense required to secure an import license or be granted the necessary foreign exchange constitute a significant obstacle to foreign trade.
- **Administrative delays:** Often the way imports are handled can be an obstacle to trade. For example, South Korean customs routinely takes 30 days or more to clear imported merchandise, adding to inventory costs and making some perishables unsaleable.
- **Reciprocal requirements:** Sometimes governments require that exporters take merchandise in lieu of money for their exports. These barter transactions are called countertrade or offsets. These requirements make the execution of a trade deal more difficult.

Restrictions on Services:

Services account for nearly 20% of the value of all international trade. Countries restrict trade in services for three main reasons:

- **Essentiality:** Countries consider certain service industries to be essential because they serve strategic purposes because they provide social assistance to their citizens. Communications, banking and utilities are examples of service industries where foreign firms are often excluded.
- **Standards:** Governments limit foreign entry into many service professions by setting standards that are difficult for foreign citizens to meet. Such licensing standards are often applied to engineers, architects, lawyers, physicians, and teachers, among others.
- **Immigration:** Clearing a foreign country’s standards is no guarantee that it will permit foreign personnel to work there. Usually governments will not grant a work permit for a foreigner until the firm can demonstrate that the skills needed for the job are unavailable locally.

THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

VER:

A voluntary export restraint (VER) may have the same effect as a quota. In a VER, another country or countries agree to not export more than a certain quantity to another country or countries. VERs are usually only enacted when it is feared that a more restrictive tariff or quota will be levied unless exports are "voluntarily" reduced. In other words, the threat of retaliation encourages compliance.

1. Import quotas and VERs benefit domestic producers and harm domestic consumers. They can also even help foreign producers, as foreign producers can raise the price they charge for the limited supply they can sell, and take the difference as additional profit.

LOCAL CONTENT REQUIREMENT:

2. Local content requirements specify that firms must produce some portion of a good domestically. The purpose of a local content requirement is usually to aid the formation of domestic industries, to keep manufacturers from switching to foreign suppliers, or to keep foreign firms from setting up "screwdriver plants." where imported manufactured components undergo simple assembly in order to avoid some other trade restriction on the importation of the fully assembled product. Domestic suppliers benefit, and domestic consumers must bear the costs.

ANTI-DUMPING LAWS:

3. Dumping occurs when a country sells goods in another country below cost or below fair market value. Dumping is a way firms can unload excess production into foreign markets. When plants must operate at a certain level regardless of domestic demand, the producer may find it appropriate to export some portion of the factory's output abroad. At times dumping may also be done for predatory reasons, hoping to drive other producers out of the market, and subsidizing foreign sales with higher domestic prices. Antidumping policies are designed to prevent dumping from occurring, or by instituting import taxes in order to bring prices of "dumped" goods back up to fair levels.

ADMINISTRATIVE ACTIONS

4. A wide range of administrative barriers can be enacted. Taking so much time to inspect goods that they spoil or setting down specific regulations on "product standards" that are very expensive to meet.

The Case for Government Intervention:

1. The most common political reason for trade restrictions is "protecting jobs and industries." Usually this results from political pressures by unions or industries that are "threatened" by more efficient foreign producers, and have more political clout than the consumers that will eventually pay the costs.

2. Keeping industries "vital for national security" viable is an oft used argument for trade restrictions. While this is reasonable for industries like steel, aerospace, and electronics, in the US the shoe industry has regularly lobbied that soldiers need boots, and thus the US needs to have a viable shoe industry in order to be able to provide shoes during a time of war.
3. Government intervention in trade can be used as part of a "get tough" policy to open foreign markets. By taking, or threatening to take, specific actions, other countries may remove trade barriers. But when threatened governments don't back down, tensions can escalate and new trade barriers may be enacted.
4. Consumer protection can also be an argument for restricting imports. The opening case suggests that the EU's concern over bananas was, in part, due to an interest in protecting consumers. Since different countries do have different health and safety standards, what may be acceptable in one country, may be unacceptable in others.
5. Concern over human rights in other countries plays an important role in foreign policy. Governments sometimes use trade policy to improve the human rights policies of trading partners. Governments also use trade policies to put pressure on governments to make other changes. In recent years the USA has had trade restrictions against Libya, Iran, Iraq, North Korea, Cuba, and other countries whose governments were pursuing policies that were not viewed favorably by the US government. Unless a large number of countries choose to take such action, however, it is unlikely to prove successful.
6. The "infant industry" argument suggests that an industry should be protected until it can develop and be viable and competitive internationally. Unless an industry is allowed to develop and achieve minimal economies of scale, foreign competitors may undercut prices and prevent a domestic industry from developing. The infant industry argument has been accepted as a justification for temporary trade restrictions under the WTO.
7. A problem with the infant industry argument is determining when an industry "grows up." Some industries that are just plain inefficient and uncompetitive have argued they are still infants after 50 years. The other problem is that given the existence of global capital markets, if the country has the potential to develop a viable competitive position, its firms should be capable of raising the necessary funds without additional support from the government.
8. Strategic trade policy suggests that in cases where there may be important first mover advantages, governments can help firms from their countries attain these advantages.
9. Strategic trade policy also suggests that governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage.

THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

Economic Rationales for Government Intervention:

Unemployment:

There is probably no more effective pressure group than the unemployed, because no other group has the time and incentive to picket or write letters in volume to government representatives. By limiting imported goods, consumers are forced to consume more goods produced domestically. This helps boost domestic employment. However, placing restrictions on imports normally results in retaliatory tariffs by other countries. In such instances, domestic jobs related to exports may be lost. Even if import restrictions do increase domestic employment, there will still be costs to some people in the domestic society in the form of higher prices or higher taxes.

Infant Industry Argument:

The infant industry argument holds that a government should guarantee an emerging industry a large share of the domestic market until it becomes efficient enough to compete against imports. However, governments have a hard time identifying which industries merit protection. Furthermore, protection for any particular industry means higher costs for local consumers, which can reduce the profitability of other domestic industries.

Industrialization Argument:

Many developing countries limit imports in an attempt to stimulate inward FDI. For example, if imported cars have to pay a high tariff, the foreign firm may decide to produce the car locally and thereby avoid the import tariff. In so doing, the auto manufacturer would help industrialize the host country's economy. The benefits of industrialization are based on several factors, as described below.

Use of surplus workers: Shifting workers from agricultural jobs to industrial jobs tends to promote economic growth since individual agricultural productivity tends to be low in less developed countries.

Promoting investment inflows: Foreign direct investment tends to accelerate the move from agriculture to industry by creating new manufacturing jobs.

Diversification: Economies based largely on the export of a single product are very vulnerable to price changes in global markets for that product or crop. Foreign investment in multiple industries helps reduce the country's dependence on a single crop or product.

Greater growth for manufactured products: The price of raw materials and agricultural commodities do not rise as fast as the prices of finished products, so over time it takes more primary products to buy the same amount of manufactured goods. Therefore, most emerging economies have become increasingly poorer compared to developed countries.

Import substitution versus export promotion: So far we have discussed why emerging economies promote industrialization. They may do so by restricting imports in order to produce locally for local consumption (import substitution). If the locally produced goods are intended to be exported (instead of

consumed locally), the country still benefits in that it now has more jobs, diversification, and greater hard currency revenues from exports.

Economic Relationships with Other Countries:

Balance of payments adjustments: Most countries would prefer to have a balanced trading position with other countries. For years, the trade deficit the United States has with Japan has been a sore spot in the relationship between the two countries. Often governments intervene to help correct these imbalances.

Comparable access or “fairness”: Many countries demand comparable access for their goods. For example, the U.S. government permits foreign financial service companies to operate in the United States, but only if their home governments allow U.S. financial service firms to operate there. However, restricting trade—even on the grounds of fairness—still leads to higher prices for domestic consumers.

Price control objectives: Countries sometimes withhold supplies from international markets (restrict trade) in order to raise prices abroad. The Organization of Petroleum Exporting Countries (OPEC) is a good example. However, restricting exports leaves unmet demand which competitors will be happy to meet.

THE POLITICAL ECONOMY OF INTERNATIONAL TRADE

The Revised Case for Free Trade:

1. While strategic trade policy identifies conditions where restrictions on trade may provide economic benefits, there are two problems that may make restrictions inappropriate: retaliation and politics.
2. Intervening to aid domestic firms will only be successful if other countries do not take similar actions that offset the effects.
3. While it could be very difficult to identify situations where strategic intervention in trade is economically appropriate, various interest groups will be certain to lobby that particular firms should be aided. Given the ease with which special interest groups seem to be able to capture the attention of the government, it is more likely that consumers will be harmed more needlessly than producers. It is unreasonable to expect the government to be completely fair and objective in “targeting” industries, when different industries, lobbies, and politicians all have their own objectives for “getting their paws in the honey pot” of governmental funds.

The Development of the World Trading System:

1. Up until the Great Depression of the 1930s, most countries had some degree of protectionism. Great Britain, as a major trading nation, was one of the strongest supporters of free trade.
2. Although the world was already in a depression, in 1930 the US enacted the Smoot-Hawley tariff, which created significant import tariffs on foreign goods. As other nations took similar steps and the depression deepened, world trade fell further.
3. After WWII, the US and other nations realized the value of freer trade, and established the General Agreement on Tariffs and Trade (GATT). [Referred to sometimes as the General Agreement to Talk and Talk.]
4. The approach of GATT was to gradually eliminate barriers to trade. Over 100 countries became members of GATT, and worked together to further liberalize trade. Figure 5.1 shows the different rounds of GATT negotiations and the resulting reductions in tariffs.
5. During the 1980s and early 1990s the world trading system as “managed” by GATT underwent strains. First, Japan’s economic strength and huge trade surplus stressed what had been more equal trading patterns, and Japan’s perceived protectionist (neo-mercantilist) policies created intense political pressures in other countries. Second, the persistent trade deficits by the US, the world’s largest economy, caused significant economic problems for some industries and political problems for the government. Thirdly, many countries found that although limited by GATT from utilizing tariffs, there were many other more subtle forms of intervention that had the same effects and did not technically violate GATT (e.g. VERs).
6. Against the background of rising protectionist pressures, in 1986 GATT members embarked on their eighth round of negotiations to reduce tariffs (called the Uruguay Round). This was the most ambitious round to date, as the goal was to expand beyond the regulation of manufactured goods

and address trade issues related to intellectual property, agriculture, services, and enforcement mechanism. Table 5.1 illustrates the main features of the agreement that was finally reached in 1993.

7. The agreement, however, left several important matters unaddressed: financial services, broadcast entertainment, environmental matters, worker's rights, and foreign direct investment. Those items were left to further negotiations under the auspices of the World Trade Organization.
8. When the WTO was established, its creators hoped the WTO's enforcement mechanisms would make it a more effective policeman of the global trade rules than the GATT had been. The WTO has handed down a number of rulings that have led to changes in governmental policies that restricted trade; in other cases governments had made changes in advance of WTO rulings.
9. Under the WTO, 68 countries that account for more than 90% of world telecommunications revenues pledged to open their markets to foreign competition and to abide by common rules for fair competition in telecommunications. The WTO has also made headway in liberalizing trade in financial services, although the current agreement still includes a number of exceptions.
10. Substantial work still remains to be done on the international trade front. Environmental policies are one area of concern, as are regulations regarding foreign direct investment.

Unit 7

GATT AND WTO**Learning Objectives:**

1. Explain the importance of GATT and the WTO to international businesses.
2. Contrast the different forms of economic integration among cooperating countries.
3. Analyze the opportunities for international businesses created by completion of the EU's internal market.
4. Describe the other major trading blocs in today's world economy.

Lesson 29**THE GENERAL AGREEMENT ON TARIFFS AND TRADE AND THE WTO:**

The General Agreement on Tariffs and Trade (GATT) is a multilateral treaty designed to minimize trade barriers. GATT went into effect in 1948. It provided a forum for trade ministers to discuss policies and problems of common concern. GATT's mission was adopted by the World Trade Organization (WTO), which replaced GATT in 1995.

The Role of the General Agreement on Tariffs and Trade:

- The goal of GATT was to promote a free and competitive trading environment that benefits efficient producers. To that end, GATT sponsored international negotiations, called "rounds," to reduce trade barriers (both tariff and nontariff). GATT successfully oversaw a reduction of tariffs from an average of over 40% in 1948 to approximately 3% today, and promoted a dramatic increase in world trade.
- To ensure that international trade is conducted on a nondiscriminatory basis, GATT follows the most favored nation (MFN) principle which requires one nation to treat a second nation no worse than it treats any third nation. Any preferential treatment that is extended to one country must be extended to all countries. Thus, the principle implies multilateral rather than bilateral trade negotiations.

Most Nations are Favored:

Though not required to do so, WTO member countries often grant MFN status to countries not belonging to the WTO. In the United States only, a few countries (such as Afghanistan, Cuba, Laos, North Korea, Libya, and Vietnam) are excluded. The Clinton administration changed the term "Most Favored Nation" (MFN) to "Normal Trade Relations" (NTR).

- There are two exceptions to the MFN clause. First, in an effort to assist poorer nations with economic development, GATT permits nations to lower tariffs to developing countries without lowering them for more developed countries. For example, the United States follows the Generalized System of Preferences (GSP) code to offer developing nations reduced tariffs. Second, regional agreements promoting economic integration such as the EU or NAFTA are exempt from the MFN clause.

- Nations following GATT principles are still able to protect domestic industries by finding loopholes in the treaty. For example, countries may adopt quotas and other non-tariff barriers yet still comply with the GATT.
- The final meeting of GATT took place in Uruguay. The round was ratified in 1994, and took effect in 1995. As in previous rounds, negotiations focused on reducing tariff barriers. Negotiations also took place to reduce non-tariff barriers to trade. Other key areas that were considered include: agricultural policy, trade in services, intellectual property rights, and the creation of the World Trade Organization.

GATT AND WTO

The World Trade Organization:

The World Trade Organization (WTO) was founded in 1995, and is comprised of 146 member countries and 30 observer countries. The WTO has three primary goals: to promote trade flows by encouraging nations to adopt non-discriminatory and predictable trade policies, to reduce remaining trade barriers through multilateral negotiations, and to establish impartial procedures for resolving trade disputes among members.

Problem Sectors:

One challenge facing the WTO is dealing with sectors of the economy such as agriculture and textiles that most nations protect. Groups including the **Cairns Group** (a group of major agricultural exporters) have pressured the WTO to ensure that the Uruguay Round policies dealing with agricultural trade are implemented according to schedule. Similarly, developing countries are monitoring the dismantling of the **Multifibre Agreement (MFA)**, which created a complex array of quotas and tariffs on trade in textiles and apparel.

The General Agreement on Trade in Services (GATS):

The WTO is also focusing on reducing barriers to trade in services. One approach currently in use is the principle of **national treatment**, in which a country treats foreign firms the same as it treats domestic firms. The WTO began negotiating a new GATS agreement in 2000, but progress has been slow.

Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS):

The third challenge for the WTO is intellectual property rights (patents, copyrights, trademarks, and brand names). Efforts to improve intellectual property right protection, agreed upon at the Uruguay round, will be phased in over the space of a decade.

In 2001, the WTO launched the **Doha round** of negotiations. Several contentious issues are slated to be discussed, including agriculture trade, intellectual property rights, and trade in services.

Trade-Related Investment Measures Agreement (TRIMS):

The TRIMS agreement is a start toward eliminating national regulations on FDI, which may distort or restrict trade. It affects trade balancing rules, foreign exchange access, and domestic sales requirements.

Enforcement of WTO Decisions:

The WTO, unlike its predecessor GATT, has more power to punish violators of the WTO rules. Most experts feel that the WTO has been successful in implementing its policies during its first years of existence.

Unit 8

FOREIGN DIRECT INVESTMENT**Learning Objectives:**

1. Describe the importance of foreign direct investment (FDI) in the world economy, and the changing patterns of FDI over time.
2. Present a number of different theories that explain why a company would undertake an acquisition rather than a Greenfield investment.
3. Present a number of different theories that attempt to explain *horizontal* FDI, and suggest the conditions under which each may be most applicable.
4. Present a number of different theories that attempt to explain *vertical* FDI, and suggest the conditions under which each may be most applicable.
5. Explain carefully the importance of market imperfections in understanding FDI, specifically as it pertains to the transfer of know-how and technological information.
6. Suggest the implications of these theories of FDI for the process of international expansion for business firms, particularly comparing licensing to FDI. A more detailed discussion of modes of entry is contained in Chapter 14.

Introduction:

- 1 The focus of this chapter is foreign direct investment (FDI). FDI can take the form of a foreign firm buying a firm in a different country, or deciding to invest in a different country by building operations there.
2. With FDI, a firm has a significant ownership in a foreign operation and the potential to affect managerial decisions of the operation.
3. The goal of our coverage of FDI is to understand the pattern of FDI that occurs between countries, and why firms undertake FDI and become multinational in their operations.
4. The opening case describes Starbucks's investments outside the US. Although concentrating originally on the franchising method of expansion and licensing of its products, Starbucks later pursued other options such as joint ventures, wholly owned subsidiaries, and acquisitions to retain tighter control over operations. This chapter will describe some of the basic theories of FDI, and why firms undertake FDI rather than simply exporting products or licensing their know-how.

FOREIGN DIRECT INVESTMENT

Foreign Direct Investment in the World Economy:

1. When discussing foreign direct investment, it is important to distinguish between the **flow** of FDI and the **stock** of FDI. The flow of FDI refers to the amount of FDI undertaken over a given time period (normally one year). The stock of FDI refers to the total accumulated value of foreign owned assets at a given point in time.
2. Figure 6.1 illustrates the great increase in the flows of FDI between 1992-2001. The significant growth in FDI has both to do with the political economy of trade as outlined in the previous chapter and the political and economic changes that have been taking place in developing countries.
3. The opening case on Starbucks helps illustrate one very important trend in FDI - the globalization of the world economy is causing firms to invest worldwide in order to assure their presence in every region of the world.
4. Another important trend is has been the rise of inflows into the US. The stock of foreign FDI in the US increased more rapidly than US FDI abroad.
5. The rapid increase in FDI growth into the US may be due to the attractiveness of the US market, the falling value of the dollar, and a belief by some foreign corporations that they could manage US assets and workers more efficiently than their American managers could.
6. It is difficult to say whether the increase in the FDI into the US is good for the country or not. To the extent that foreigners are making more productive use of US assets and workers, it is probably good for the country.
7. Figures 6.2, 6.3, 6.4 and 6.5 provide some insight into the countries that have been the major recipients and sources of foreign direct investment in recent years.
8. The management focuses box details the techniques of Mexican cement manufacturer Cemex for its aggressive international expansion of cement manufacturing. Because cement is a product that is not easily exported due to its low ratio of value to weight, Cemex sought international expansion by acquisition.

Horizontal Foreign Direct Investment:

1. Horizontal FDI is FDI in the same industry abroad as a firm operates in at home. A Japanese automobile manufacturer in Japan seeks to produce the same product in the US. FDI would seem to be more expensive and risky than exporting or licensing, so there must be some other good reasons for firms to undertake FDI.
2. Transportation costs can make export infeasible, especially for products that have a low value/weight ratio (i.e. cement, soft drinks), or would require refrigeration or similar controlled environments. For items like electronics, software, and medical equipment, transportation costs may not be an impediment to exporting.

3. The most accepted reason for horizontal FDI relates to market imperfections. By imposing quotas, tariffs, or impediments, governments can make FDI and licensing more attractive than exporting.
4. Technological or managerial know-how can be difficult and dangerous to license, however, making it an infeasible alternative. A firm can lose control of critical competitive know-how, may not be able to optimize the flow and configuration of operations between countries, or simply may be unable to codify its knowledge in a way that would make licensing a practical option.
5. Firms may choose to undertake FDI simply to follow the lead of a competitor so as not be left behind or locked out of an opportunity.
6. FDI may be most likely to occur in certain stages of a product's lifecycle - when other countries have a large enough market to justify local production or when there is a need to locate production in a low cost location.
7. A firm may choose to undertake FDI in a particular country or region due to location specific advantages. An obvious example occurs with respect to natural resources, but it also applies to the ability to tap into a particular expertise (e.g. Silicon Valley) or be located near customers or suppliers with unique characteristics. Porter's diamond, as discussed in chapter 4, provides a partial explanation why firms in certain industries may find it attractive to invest in a particular country.

Vertical Foreign Direct Investment:

1. Backward vertical FDI involves investment into an industry that provides inputs for a firm's domestic production processes. Forward vertical FDI involves investment in an industry that utilizes the outputs of a firm's domestic production processes.
2. The strategic behavior explanation for vertical FDI suggests that firms try to either create new entry barriers or erode competitors' entry barriers. While there certainly are some examples where the strategic behavior explanation seems to apply, the market imperfections explanation seems to present a more complete explanation.
3. Market imperfections can result from impediments to the sale of know-how and the need to invest in specialized assets.
4. Because specialized know-how can be difficult to sell or license, a firm may have to integrate vertically to be successful. The establishments of sales and services centers in high technology industries or the investment in knowledge intensive extractive processes are two examples.
5. When specialized assets must be invested in (i.e. the aluminum smelter), companies may need to secure a supply of the needed inputs to assure that those assets can be used efficiently.

FOREIGN DIRECT INVESTMENT

Learning Objectives:

- To explain why investors and governments view direct investments differently than portfolio investments
- To demonstrate how companies acquire foreign direct investments
- To evaluate the relationship between foreign trade and international factor mobility, especially direct investment
- To classify companies' motivations for foreign direct investment
- To explain companies' advantages from foreign direct investments
- To show the major global patterns of foreign direct investment

Types of International Investments:

- International investment can be divided into **portfolio investment** and **foreign direct investment** (FDI) (see Chapter 1). The former represents passive holdings of foreign stocks, bonds, or other financial assets that entail no active management or control of the issuer of the securities by the foreign investor. The latter represents acquisition of foreign assets for the purpose of control.
- FDI may take many forms including: purchases of existing assets in a foreign country; new investments in plant, property, and equipment; or participation in joint ventures with a local partner. The text provides examples of each type of investment.
- Controversy often surrounds FDI because while it may increase employment, enhance productivity, and raise wage rates, it also raises concerns that control of the national economy is being passed to foreigners.

The Growth of Foreign Direct Investment:

- The past 30 years have seen a dramatic rise in foreign direct investment. Current worldwide FDI is about \$6.8 trillion (2001).

Foreign Direct Investment in the United States:

- The United Kingdom has accounted for the greatest portion of FDI into the United States.
- The high levels of FDI to Bermuda, the Bahamas, and other small Caribbean islands relate to their role as offshore financial centers.
- Over the past decade, outward FDI has remained larger than inward FDI for the United States, but both categories have more than doubled in size.

INTERNATIONAL INVESTMENT THEORIES:

Ownership Advantages:

- Researchers trying to explain why FDI occurs initially focused on the impact of firm-specific (or monopolistic) advantages. They argued that a firm that owned a superior technology, a well-known brand name, or economies of scale that created a monopolistic advantage could clone its domestic

advantage to penetrate foreign markets. The text provides the example of Caterpillar and Komatsu, both of which capitalized on proprietary technology and brand names to expand into other markets.

Internalization Theory:

- The answers to the questions outlined above were explored using **internalization theory**. The theory suggests that FDI is more likely to occur (a firm will internalize its operations) when the costs of negotiating, monitoring, and enforcing a contract (**transaction costs**) with a second firm are high.

Dunning's Eclectic Theory:

Dunning's eclectic theory ties together location advantage, ownership advantage, and internalization advantage. Dunning proposes that FDI will take place when three conditions are satisfied.

- First, the firm must own some unique competitive advantage that overcomes the disadvantages of competing with foreign firms in their own market (**ownership advantage**).
- Second, it must be more profitable to undertake a business activity in a foreign location than a domestic location (**location advantage**).
- Third, the firm must benefit from controlling the foreign business activity, rather than hiring an independent local company to provide the service (**internalization advantage**).

FOREIGN DIRECT INVESTMENT

METHODS OF ACQUISITION:

Companies may accumulate foreign assets through acquisition (buying them) or by building these assets themselves.

Resources for Acquisition:

In order to acquire a foreign asset, firms usually move capital from one country (often the home country) to the country where the newly acquired facility is located (the host country). Sometimes, if the firm already has operations in the host country, it can simply use revenues from host country operations to acquire another facility. In such instances, no international capital movement would occur.

Buy versus Build Decision:

Instead of buying an existing foreign operation, the investing firm might decide to build a new facility from scratch.

Reasons for buying: The investing company might wish to acquire a locally existing name brand, might wish to avoid adding additional capacity to the industry, might wish to avoid having to hire and train new workers. Furthermore, by buying an existing company, the investor avoids inefficiencies during the start-up period and gets an immediate cash flow rather than tying up funds during construction.

Reasons for building: Companies often make investments where there is little or no competition, so finding a firm to buy may be difficult. Furthermore, when acquiring a firm, the investor inherits all the problems that exist in the firm. Finally, a foreign company may find local financing easier to obtain if it builds facilities.

THE RELATIONSHIP OF TRADE AND FACTOR MOBILITY

Trade Theories and Factor Mobility:

Factor movement is often an alternative to trade. If a Japanese firm buys a U.S. auto manufacturing facility, the factor (capital) movement will replace future trade (imports of autos manufactured in Japan) since the cars will now be produced by the Japanese firm in the United States.

Substitution:

When factor proportions vary widely among countries, pressures exist for the most abundant factors to move to countries with greater scarcity. If labor is abundant in Mexico (high unemployment) but scarce in the United States (low unemployment), Mexican labor will try to move to the United States. It might be cheaper in the end to allow Mexican labor into the United States to produce goods for the U.S. market than to simply import those goods from Mexico (see Figure 8.2 numerical example in chapter).

Complementarity of Trade and Direct Investment:

FDI usually affects trade. It can increase the recipient country's exports of new products. It can increase the recipient country's imports of equipment. It can also restrict trade when accompanied by local content laws or when local production substitutes for previously imported goods.

Relationship of FDI to Companies' Objectives:

FDI allows companies to achieve their goals of expanding sales, acquiring resources, and/or minimizing risk.

FDI MOTIVATIONS TO ACHIEVE SALES EXPANSION**Transportation:**

When companies add the cost of transportation to production costs, some products become impractical to ship over great distances. For these companies, it is necessary to produce abroad if they are to sell abroad. When companies move abroad to produce basically the same products they produce at home, their direct investments are horizontal expansions.

Lack of plant capacity: Domestic capacity may adequately serve the domestic market (if there is excess capacity domestically, firms will usually produce domestically and export their surplus). If firms need to create additional capacity in order to serve foreign demand, it is likely that they will create capacity near the markets it is intended to serve.

Scale economies: Firms that can achieve significant economies of scale on the production of their products will normally centralize production and export from the central production location. When firms need to tailor their products to individual markets, they are unable to achieve significant scale economies and will be more likely to produce differentiated products in a variety of foreign locations.

Trade Restrictions:

Governments often restrict imports. Consequently, a firm may find that they must produce in a foreign country if they are to sell there.

Country-of-Origin Effects:

Consumers have a favorable disposition to certain product/country combinations (for example, French perfume, Japanese cameras, and German cars). Therefore, there may be benefits to producing certain types of products in specific locations.

Nationalism: Local consumers may wish to purchase locally produced goods (e.g., "buy American" campaigns in the USA).

Product image: As mentioned above, consumers may choose a product based on where it was manufactured (e.g., German cars).

Delivery risk: Service and replacement parts for foreign items are often expensive or difficult to obtain. Industrial consumers especially may be willing to pay a higher price to a nearby producer in order to reduce the risk of no delivery due to distance.

Changes in Comparative Costs:

A company may export because its home country has a cost advantage. However, changes in productivity and foreign exchange values may reverse comparative cost advantages, leading the firm to decide to engage in foreign direct investment.

FDI MOTIVATIONS TO ACQUIRE RESOURCES:**Vertical Integration:**

Companies may engage in FDI in order to secure inputs to their production process or in order to control foreign distribution channels for their products. These are examples of vertical integration.

Rationalized Production:

Some companies produce different components or different portions of their product line in different parts of the world to take advantage of low labor costs, capital, and raw materials. This way each component can be produced in the country where conditions are most suited to manufacturing that particular item.

Access to Production Resources:

Many non-U.S. companies have offices in New York City to gain better access to what is happening in the U.S. capital market. Conversely, McGraw-Hill established an office in Europe to allow its personnel there to uncover European technical developments by visiting universities, trade associations, and companies.

The Product Life Cycle Theory:

According to the product life cycle theory discussed in Chapter 5, production will move from the home country in the early stages of the product's life cycle, to other developed countries, and finally to developing countries.

FOREIGN DIRECT INVESTMENT

RISK MINIMIZATION OBJECTIVES:

Diversification, internationally or otherwise, is often a means firms use to reduce risks.

Following Customers:

Suppliers will often set up facilities near the firms they supply. Bridgestone decided to make automobile tires in the United States in order to continue selling to Honda and Toyota once those companies initiated U.S. production.

Preventing Competitors' Advantages:

Firms in an oligopolistic industry often follow their competitors into other countries in order to avoid giving a competitor an advantage.

Political Motives:

For example, during the early 1980s, the U.S. government instituted various incentives to increase the profitability of U.S. investment in Caribbean countries that were unfriendly to Castro's regime.

ADVANTAGES OF FOREIGN DIRECT INVESTMENT:

Monopoly Advantages before Direct Investment:

Companies invest directly if they think they hold some supremacy over similar companies in countries of interest. The advantage results from a foreign company's ownership of some resource—patents, management skills—unavailable at the same price to the local company. This edge is often called a monopoly advantage.

Advantages after Direct Investment:

To support the high costs necessary to maintain domestic competitiveness, companies frequently must sell on a global basis. To sell most efficiently, many companies establish direct investments abroad that take advantage of location economies in various value chain activities.

DIRECT INVESTMENT PATTERNS:

Location of Ownership:

Industrial countries account for over 90% of all direct investment outflows.

Location of Investment:

The major recipients of FDI are developed countries, which received about 71% of the world's total in 1998. FDI often flows to developed countries because their markets tend to be larger; they face less political turmoil, and tend to have liberal direct investment policies.

Economic Sector of Investment:

Over time, FDI in mining, smelting, and petroleum has declined. In the 1980s and 1990s, FDI in the service sector (especially banking and finance) grew rapidly, as did FDI in technology-intensive manufacturing.

FDI in Companies' Strategies:

Direct investment is an integral means of carrying out global, multidomestic, and transnational strategies. Direct investments help to serve global efficiency by transferring resources to where they can be used more effectively.

LOOKING TO THE FUTURE

Will FDI continue to grow worldwide?

Probably yes, though if trade restrictions continue to fall, import-substitution FDI will decrease in importance. It will probably continue to flow primarily into developed economies, though the relative share flowing into developing countries is likely to grow if developing economies continue to stabilize.

ETHICAL DILEMMAS AND SOCIAL RESPONSIBILITY

Critics debate the ethics of FDI and employment

Acme boots announced it was moving from the continental United States to Puerto Rico to gain tax advantages. The move stranded U.S. employees, some of whom had thirty years of service with the company. On the one hand, direct investment may lead to better use of global resources. On the other hand, it is the workers who suffer if they lose their jobs and cannot easily find new ones.

Implications for Business

1. The market imperfections theory suggests that exporting should be preferred to licensing and horizontal FDI as long as transport costs are minor and tariff barriers are trivial. If that is not the case, then firms should consider licensing and FDI.
2. FDI is more costly than licensing, but may be the most reasonable option. Figure 6.6 presents a decision tree suggesting when licensing, FDI, and exporting are most appropriate.
3. Licensing tends not to be a good option in high technology industries where protecting firm specific know-how is critical, in industries where a firm must carefully coordinate and orchestrate its worldwide activities, or where there are intense cost pressures.

Absolute Advantage:

- **Adam Smith** criticized the mercantilist philosophy, arguing that it confused the acquisition of treasure with the acquisition of wealth. He further pointed out that mercantilism actually weakens a nation because it forces a country to produce products that it is not very good at producing, and in doing so does not maximize the wealth of its citizens.
- **Smith proposed** that free trade between nations would actually enlarge the wealth of countries because it would allow a country to specialize in the production of products that it is good at producing and trade for other products.

Smith's theory of **absolute advantage** states that a nation should produce those goods and services that it can produce more cheaply than other countries. The country should then trade for goods and services that it is not good at producing. The theory is demonstrated numerically in the text using

The **product life cycle** theory, developed by Vernon, consists of three stages. In the first stage (the new product stage), a company develops and introduces an innovative product in response to a perceived need

in the local market. Initially, the company must closely monitor whether the product indeed satisfied customer needs, and so typically, the product is introduced in the country where the product was developed. In addition, because the firm is initially likely to minimize its manufacturing investment, most output is sold in the domestic market

Dunning's Eclectic Theory

Dunning's eclectic theory ties together location advantage, ownership advantage, and internalization advantage. Dunning proposes that FDI will take place when three conditions are satisfied.

- **First**, the firm must own some unique competitive advantage that overcomes the disadvantages of competing with foreign firms in their own market (ownership advantage).
- **Second**, it must be more profitable to undertake a business activity in a foreign location than a domestic location (location advantage).
- **Third**, the firm must benefit from controlling the foreign business activity, rather than hiring an independent local company to provide the service (internalization advantage).

EXTERNALITIES

In addition to the fact that laws vary among countries, strong home-country governments may attempt to extend their legal influence to foreign countries. **Extraterritoriality** refers to the extension by a government of the application of its laws to the foreign operations of its domestic firms. In cases of health and safety regulations, differences may not be insurmountable, but in other instances, home- and host-country laws clearly conflict. Civil law nations tend to have a large body of law dealing with business operations, but common law nations rely more on precedent than statutory regulations. Externalities refer to the by-products of activities that affect the well-being of people and/or the environment. Although **externalities** are not reflected in standard cost accounting practices, they must be included in the calculation of stakeholder value.

FOREIGN DIRECT INVESTMENT

Pragmatic Nationalism

- Having nor a radical neither a free trade market.
- FDI has both benefits and disadvantages to a country.
- Some Pragmatic nationalist are thinking in terms of resources taken out by MNE in the repatriation resulted from FDI.
- Japan, Korea, Latin American Countries are the Examples.
- But recent years have seen a major increase in FDI.

Growth and Employment Effects:

In contrast to the balance-of-payments effects, the effects of FDI on economic growth and employment should not be a zero-sum game because MNEs may use resources that were either underemployed or unemployed. The argument that both home and host countries can gain from FDI rests on two assumptions: (i) resources are not fully employed and (ii) capital and technology cannot be easily transferred from one activity to another.

- **Home Country Losses:** As manufacturers seek lower-cost foreign production sites, home countries claim that FDI outflows create jobs abroad at the expense of jobs in the home country.
- **Host Country Gains:** Host countries gain through the transfer of capital, technology, and managerial expertise, as well as the creation of new jobs.
- **Host Country Losses:** Critics argue that FDI inflows often displace domestic investment and drive up local labor costs. They claim that MNEs have access to lower-cost funds than local competitors do and that MNEs can spend more on promotion activities. In addition, while it is true that MNEs often source inputs locally, critics claim that they also destroy local entrepreneurship. Further, as MNEs gain valuable knowledge in their foreign operations that can be shared across their entire organizations, critics fear that local firms subsequently suffer a competitive disadvantage.

Obtain Resources and Benefits

Access to Technology:

Nations encourage FDI in technology because it increases productivity and competitiveness.

Management Skills and Employment:

FDI allows talented foreign managers to train local managers in how to operate the local facilities—this is important for former communist nations that lack skilled managerial talent. Some of these managers will also go on to establish their own businesses.

Reasons for Home Nation Intervention:

There are fewer concerns regarding the outflow of FDI among home nations because they tend to be prosperous, industrialized nations.

Reasons for discouraging outward FDI

- Investing in other nations sends resources out of the home country and can lessen investment at home.
- Outgoing FDI may damage a nation's balance of payments by reducing exports otherwise sent to international markets.
- Jobs resulting from outgoing investments may replace jobs at home.

Reasons for promoting outgoing FDI

- Outward FDI can increase long-run competitiveness (e.g., Japanese use FDI and partnering as learning opportunities).
- Nations may encourage FDI in “sunset” industries, those that use outdated and obsolete technologies or employ low-wage workers with few skills.

Host Countries: Promotion:**Financial Incentives:**

- Host governments commonly offer tax incentives and/or low-interest loans to attract investment.
- However, incentives can create bidding wars between locations vying for investment; the cost to taxpayers of snaring FDI can be more than what the actual jobs pay.

Infrastructure Improvements:

- Lasting benefits for communities surrounding the investment location can result from local infrastructure improvements—better seaports for containerized shipping, improved roads, and increased telecommunications systems.
- Example: \$40 billion Multimedia Super Corridor (MSC) being constructed in Malaysia in forested surroundings.

Host Countries: Restriction:**Ownership Restrictions:**

- Governments impose ownership restrictions that prohibit non-domestic companies from investing in certain industries or owning certain types of business (e.g., Western investment is controversial in the Middle East).
- Another restriction is a requirement that non-domestic investors hold less than a 50% stake in local firms. Nations are eliminating such restrictions because companies can choose another location.

Performance Demands:

- Performance demands influence how international companies operate in the host nation. Some performance demands dictate the portion of a product's content that originates locally, stipulates the portion of output that must be exported, or requires that certain technologies be transferred to local businesses.

Home Countries: Promotion

To encourage outbound FDI, home countries can:

- Offer insurance to cover the risks of investments abroad.
- Grant loans to firms wishing to increase their investments abroad.
- Offer tax breaks on profits earned abroad or negotiate special tax treaties.
- Apply political pressure on other nations to get them to relax their restrictions on inbound investments.

Home Countries: Restriction

To limit the negative effects of outgoing FDI, home governments can:

- Impose differential tax rates that charge income from earnings abroad at a higher rate than domestic earnings.
- Impose sanctions that prohibit domestic firms from making investments in certain nations.

Shifting Ideology:

Radical thinking adherence by many countries .Though pure free market is sometimes criticized by pragmatic nationalists like Japn , Korea,Italy, Span and most latin American countries. But on the other hand we can see a dramatic change and increase in FDi.

FOREIGN DIRECT INVESTMENT

Employment:

There is probably no more effective pressure group than the unemployed, because no other group has the time and incentive to picket or write letters in volume to government representatives. By limiting imported goods, consumers are forced to consume more goods produced domestically. This helps boost domestic employment. However, placing restrictions on imports normally results in retaliatory tariffs by other countries. In such instances, domestic jobs related to exports may be lost. Even if import restrictions do increase domestic employment, there will still be costs to some people in the domestic society in the form of higher prices or higher taxes.

Balance of Payments:

1. A country's balance of payments is a national accounting system that records all payments to entities in other countries and all receipts coming into the nation.
2. International transactions that result in payments (outflows) to entities in other nations are reductions in the balance of payments accounts and recorded with a minus (-) sign.
3. International transactions that result in receipts (inflows) from other nations are additions to the balance of payments accounts and recorded with a plus (+) sign.

Balance of Payments:

1. Many governments see intervention as the only way to keep their balance of payments under control.
2. Countries get a balance-of-payments boost from initial FDI flows into their economies. Local content requirements can lower imports, providing a balance-of-payments boost. Exports generated by production resulting from FDI can help the balance-of-payments position.
3. When companies repatriate profits, they deplete the foreign exchange reserves of their host countries; these capital outflows decrease the balance of payments. To avoid this, the host nation may prohibit or restrict the non-domestic company from removing profits.
4. Alternatively, host countries conserve their foreign exchange reserves when international companies reinvest their earnings in local manufacturing facilities. This improves the competitiveness of local producers and boosts a host nation's exports—improving its balance-of-payments position.

Current Account:

The **current account** is a national account that records transactions involving the import and export of goods and services, income receipts on assets abroad, and income payments on foreign assets inside the country.

A **current account surplus** occurs when a country exports more goods and services and receives more income from abroad than it imports and pays abroad. A current account deficit occurs when a country imports more goods and services and pays more abroad than it exports and receives from abroad.

Capital Account:

The **capital account** is a national account that records transactions involving the purchase or sale of assets. These assets include financial assets such as stocks and bonds and physical assets such as investments in plants and equipment (e.g., If a U.S. firm invests in a company on Mexico's stock market, the transaction shows up on the capital accounts as an outflow from the U.S. and an inflow to Mexico).

FOREIGN DIRECT INVESTMENT

Reasons for Host Nation Intervention:

Balance of Payments:

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- b. Countries get a balance-of-payments boost from initial FDI flows into their economies. Local content requirements can lower imports, providing a balance-of-payments boost. Exports generated by production resulting from FDI can help the balance-of-payments position.
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Reasons for promoting outgoing FDI:

- a. Outward FDI can increase long-run competitiveness (e.g., Japanese use FDI and partnering as learning opportunities).
- b. Nations may encourage FDI in “sunset” industries, those that use outdated and obsolete technologies or employ low-wage workers with few skills.

Implications for Business:

1. The market imperfections theory suggests that exporting should be preferred to licensing and horizontal FDI as long as transport costs are minor and tariff barriers are trivial. If that is not the case, then firms should consider licensing and FDI.
2. FDI is more costly than licensing, but may be the most reasonable option. Figure 6.6 presents a decision tree suggesting when licensing, FDI, and exporting are most appropriate.
3. Licensing tends not to be a good option in high technology industries where protecting firm specific know-how is critical, in industries where a firm must carefully coordinate and orchestrate its worldwide activities, or where there are intense cost pressures.

Unit 9

REGIONAL AND ECONOMIC INTEGRATION**Learning Objectives:**

- What is regional integration
- How political and Geographical Blocks changes in to financial blocks.
- Need of regional integration in the presence of GATT & WTO.
- Other regional forums of the world.

Introduction:

1. The previous chapters presented the case for the free movement of goods and capital. While there have been decreases in the global barriers to trade and investment, the greatest progress had been made on a regional basis.
2. An example from the current popular press on the EU (or NAFTA) and the effects the EU (or NAFTA) has had on a particular business or industry would help illustrate the point. The opening case can be used to highlight how EU insurance liberalization has affected national firms in the insurance industry. The closing case on Deutsche Bank is another example. The case on Deutsche shows that the development of the EU and the implementation of the euro can have major effects on the structure of an international firm.
3. Perhaps the best example of the benefits of economic integration and political union is the USA. Before the current constitution was written, the 13 colonies had erected significant barriers to trade between each other and had separate currencies. Seeing that this was not working well, and wanting a better system for their citizens, the founding fathers agreed to combine their separate states into a United States. Whether the EU, with its significant cultural and language differences in neighboring countries, can achieve similar benefits remains to be seen.
4. The notion of regional economic integration is becoming increasingly important as countries strive to work together better and become more productive. While integration takes place at a much broader level under the WTO, local regions with fewer countries to argue amongst have the ability to make much greater strides.
5. Integration creates both winners and losers, however. An important challenge facing many firms and governments is what should be done to minimize the costs of transition to freer markets regionally as well as internationally.

REGIONAL AND ECONOMIC INTEGRATION

The Role of the General Agreement on Tariffs and Trade (GATT):

The goal of GATT was to promote a free and competitive trading environment that benefits efficient producers. To that end, GATT sponsored international negotiations, called “rounds,” to reduce trade barriers (both tariff and nontariff). GATT successfully oversaw a reduction of tariffs from an average of over 40% in 1948 to approximately 3% today, and promoted a dramatic increase in world trade.

To ensure that international trade is conducted on a nondiscriminatory basis, GATT follows the **most favored nation (MFN)** principle which requires one nation to treat a second nation no worse than it treats any third nation. Any preferential treatment that is extended to one country must be extended to all countries. Thus, the principle implies multilateral rather than bilateral trade negotiation

The World Trade Organization:

- **The World Trade Organization (WTO)** was founded in 1995, and is comprised of 146 member countries and 30 observer countries. The WTO has three primary goals: to promote trade flows by encouraging nations to adopt non-discriminatory and predictable trade policies, to reduce remaining trade barriers through multilateral negotiations, and to establish impartial procedures for resolving trade disputes among members.
- **Problem Sectors:** One challenge facing the WTO is dealing with sectors of the economy such as agriculture and textiles that most nations protect. Groups including the Cairns Group (a group of major agricultural exporters) have pressured the WTO to ensure that the Uruguay Round policies dealing with agricultural trade are implemented according to schedule. Similarly, developing countries are monitoring the dismantling of the Multifibre Agreement (MFA), which created a complex array of quotas and tariffs on trade in textiles and apparel.
- **The General Agreement on Trade in Services (GATS):** The WTO is also focusing on reducing barriers to trade in services. One approach currently in use is the principle of national treatment, in which a country treats foreign firms the same as it treats domestic firms. The WTO began negotiating a new GATS agreement in 2000, but progress has been slow.
- **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS):** The third challenge for the WTO is intellectual property rights (patents, copyrights, trademarks, and brand names). Efforts to improve intellectual property right protection, agreed upon at the Uruguay round, will be phased in over the space of a decade.
- **In 2001,** the WTO launched the Doha round of negotiations. Several contentious issues are slated to be discussed, including agriculture trade, intellectual property rights, and trade in services.
- **Trade-Related Investment Measures Agreement (TRIMS):** The TRIMS agreement is a start toward eliminating national regulations on FDI, which may distort or restrict trade. It affects trade balancing rules, foreign exchange access, and domestic sales requirements.

- **Enforcement of WTO Decisions:** The WTO, unlike its predecessor GATT, has more power to punish violators of the WTO rules. Most experts feel that the WTO has been successful in implementing its policies during its first years of existence.

THE EUROPEAN UNION

- The European Union (EU) is the most important trading bloc in the world today. Fifteen countries currently “belong” to the EU, making it the world’s richest market, with a total GDP of \$7.9 trillion.
- Ten more countries are slated to join the EU in 2004. .
- The European Economic Community (EEC) was established at the Treaty of Rome in 1957 by six nations (Belgium, France, Luxembourg, Germany, Italy, and the Netherlands). The goal of the EEC was to create a common market. The name EU was a result of a name change in 1993.

The North American Free Trade Agreement:

The **North American Free Trade Agreement (NAFTA)** was implemented in 1994 to reduce barriers to trade and investment among Canada, Mexico, and the United States. The agreement was built upon a trade agreement that had been signed between the United States and Canada six years earlier and upon the extensive amount of trade that already existed between the three countries. The agreement will be phased in over a 15-year period.

Free Trade Area

- A free trade area eliminates all barriers to trade among member countries, but allows each country to establish its own external trade barriers. The North American Free Trade Area (NAFTA) is an imperfect example of a free trade area.
- A problem with free trade areas is the potential for **trade deflection** whereby non-member countries try to avoid trade barriers by initially exporting their products to a member country with low trade barriers, then re-exporting the products to a member country with high trade barriers.
- Most free trade agreements specify **rules of origin**, which detail the conditions under which a good is classified as a member or non-member good to try to prevent trade deflection.

Customs Union:

A **customs union** combines the elimination of barriers to internal trade among member countries with the adoption of common external trade policies toward non-members. Trade deflection is not an issue in a customs union since member countries treat non-members in a uniform manner. A current example of a customs union is the Mercosur Accord, an agreement between Argentina, Brazil, Paraguay, and Uruguay.

Economic Union:

An **economic union** eliminates trade barriers between member countries, establishes a common external trade policy, follows a policy of factor mobility, and coordinates economic policies of member countries. An example of an economic union is the Belgium-Luxembourg Economic Union. In addition, the European Union is currently moving toward economic union status.

Political Union:

- A **political union** combines the elements of an economic union with the added feature of complete political integration. The United States, transformed from 13 separate colonies into one, is an example of a political union.
- The **Mercosur Accord** is an agreement between Argentina, Brazil, Paraguay, and Uruguay to cut internal tariffs and establish common external tariffs. The agreement is expected to revitalize the stagnating economies of Brazil and Argentina by stimulating new flows of FDI.
- The **Association of South East Asian Nations (ASEAN)** was founded in 1967 by Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand to promote regional political and economic cooperation.

REGIONAL AND ECONOMIC INTEGRATION

The Case for Regional Integration:

1. The economic case for integration has been largely presented in the previous chapters. Free trade and movement of goods, services, capital, and factors of production allow for the most efficient use of resources. That is positive sum game, as all countries can benefit.
2. Regional economic integration is an attempt to go beyond the limitations of WTO. While it is hard for 100 countries to agree on something, (e.g., the United Nations) it is much more likely that only a few countries with close proximity and common interests will be able to agree to even fewer restrictions on the flows between their countries.
3. The political case for integration has two main points: 1) by linking countries together, making them more dependent on each other, and forming a structure where they regularly have to interact, the likelihood of violent conflict and war will decrease. 2) by linking countries together, they have greater clout and are politically much stronger in dealing with other nations.
4. In the case of the EU, both a desire to decrease the likelihood of another world war and an interest in being strong enough to stand up to the US and USSR were factors in its creation.
5. There are two main impediments to integration: 1) there are always painful adjustments, and groups that are likely to be directly hurt by integration will lobby hard to prevent losses, 2) concerns about loss of sovereignty and control over domestic interests. Canada has always been concerned about being dominated by its southern neighbor, and Britain is very hesitant to give much control to European bureaucrats (as of this writing it still has not adopted the euro).
6. The case on NAFTA and the US Textile Industry shows that although the effects of NAFTA have hurt employment in the US textile industry, the overall effect has actually been positive. The reason: clothing prices have fallen, exports have increased, and sales to apparel factories have surged. Those factors more than compensate for the loss of jobs.

The Case against Regional Integration:

1. Many groups within a country do not accept the case for integration, especially those that are likely to be hurt or those that feel that sovereignty and individual discretion will be reduced. Thus, it is not surprising that most attempts to achieve integration have progressed slowly and with hesitation.
2. Whether regional integration is in the economic interests of the participants depends upon the extent of trade creation as opposed to trade diversion. Trade creation occurs when low cost producers within the free trade area replace high cost domestic producers. Trade diversion occurs when higher cost suppliers within the free trade area replace lower cost external suppliers. A regional free trade agreement will only make the world better off if the amount of trade it creates exceeds the amount it diverts.

Regional Economic Integration in Europe:

1. Map 8.1 identifies the member countries of the EU. The EU is large economically and politically, and many of the independent countries that were under the influence of the former USSR have sought to join the EU.
2. The forerunner of the EU was the European Coal and Steel Community, which had the goal of removing barriers to trade in coal, iron, steel, and scrap metal formed in 1951. The Treaty of Rome formed the EEC in 1957. While the original goal was for a common market, progress was generally very slow.
3. Over the years the EU expanded in spurts, as well as moved towards ever-greater integration.
4. Many countries that are now members of the EU were initially members of EFTA who either felt that the EU was pushing for too much integration too fast, or were denied entry by other member states. Norway, while always a member of EFTA, has twice had its citizen vote down membership in the EU because they felt they would lose too much control to their much bigger neighbors to the south. Being a small country, they felt they would have little say in policies, and would be forced to adopt policies that were unfavorable to their prospering oil and fisheries industries. (And it is generally true that the EU would like to have the benefits from these industries spread around.) Nevertheless, since most of Norway's trade is with EU member countries, it has chosen to adopt many EU regulations - and is in fact in greater compliance with EU regulations than some of the EU member states.
5. The economic policies of the EU are formulated and implemented by a complex and still evolving political structure. The five main institutions are the European Council, the Council of Ministers, the European Commission, the European Parliament, and the Court of Justice. Although they are described in some detail in the book, you may not feel that it is important to lecture on these administrative topics.
6. The problems with lack of progress on the objectives of the EU resulted in a number of problems for firms and governments, and led to adoption of the Single European Act in 1987. The Single European Act called for the removal of border controls, mutual recognition of standards, open public procurement, a barrier free financial services industry, no currency exchange controls, free and open freight transport, and freer and more open competition.
7. The Management Focus on the EU and the media industry mergers shows the power that the EU has acquired in controlling and regulating mergers of international companies. Through the use of concessions, the EU has been able to dramatically change the shape of an entire industry.
8. The Treaty of Maastricht took the EU one step further, by specially spelling out the steps to economic union and partial political union. In addition to simply spelling out the steps needed, the Treaty also laid out the future outlines of a common foreign policy, economic policy, defense policy, citizenship, and currency, as well as strengthened the role of the European Parliament. The single currency will eliminate exchange costs and reduce risk, making EC firms more efficient.

9. The Euro was officially launched on January 1, 1999. It became into full use On January 1, 2002. Member states that have entered into monetary union have fixed exchange rates with the Euro, and hence with each other. The Euro reduces both exchange rate costs and risks, and has been used for many business transactions. The use of national currencies was discontinued in 2002 in favor of the euro, although many member banks will accept their national currency in exchange for the euro. Adoption of the Euro will help citizens more easily compare prices, should increase cross border competition, and lead to lower costs for consumers.
10. Britain, Denmark, and Sweden have chosen to opt out of joining EMU for now. One reason is a concern over losing control over monetary policy to the European Central Bank. Some believe that currency union should only take place after political union.
11. A number of countries have applied for membership in the EU, particularly from Eastern Europe. Given the profound differences in income, development, and systems, however, makes near term integration of these countries into the EU difficult.
12. Many firms and countries (including the EFTA countries) are concerned that the EU will result in a "fortress Europe," where insiders will be given preferential treatment over outsiders. That clearly already exists in agriculture, although whether it will be extended to other areas is a matter of debate.

Implications for Business:

1. Economic integration creates a number of significant opportunities for business. Larger markets can now be served, additional countries open to trade, and greater economies of scale achieved.
2. The greatest implication for MNEs is that the free movement of goods across borders, the harmonization of product standards, and the simplification of tax regimes, makes it possible for them to realize potentially enormous cost economies by centralizing production in those locations where the mix of factor costs and skills is optimal. By specialization and shipping of goods between locations, a much more efficient web of operations can be created.
3. The lowering of barriers to trade and investment between countries will be followed by increased price competition, requiring firms to rationalize production and reduce costs if they are to remain competitive.
4. As other firms become more competitive in their home markets (now expanded), they may be able to enter additional markets and threaten local firms' positions.
5. Firms also must be concerned that they may be "locked out" of "fortress Europe" or "fortress North America," and thus may need to establish operations with a region if they are to remain an active player in the market.

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Governing the European Union:

1. The EU is governed by four organizations. The **Council of the Economic Union**, made up of 15 members, each of whom is responsible to his or her home government, is the EU's main decision making body. Because of its composition, the Council reflects the desire of member states to retain national sovereignty and power. The **European Commission** is composed of 20 individuals whose loyalty is to the EU rather than their home countries. Its mandate is to be "guardian of the Treaties." The **European Parliament**, made of 626 elected representatives, is the weakest of the governing bodies. It originally acted in a consultative manner in EU policy making, but has expanded its role under the Maastricht Treaty. Finally, the **European Court of Justice** interprets the meaning of EU law and ensures that EU regulations and policies are followed by member states.
2. The Legislative Process. The legislative process in the EU, which is usually initiated by the Commission, is a complicated one. In fact, transforming a Commission proposal into law may take years. The complex process reflects the desires of member countries to retain their sovereignty yet create a supranational government.

Lobbying the European Union:

This Global Learning Box discusses how firms can influence EU decision makers in their legislative actions. EU decision makers have the difficult job of juggling the diverse interests of member nations, and consequently may not take into consideration the interests of foreign firms. Lobbying either the Commission or an ally on the Council may prevent adverse legislative proposals from being passed. This box fits in well with a discussion of the EU, with a discussion of trade barriers, and with Discussion Questions 2, 3, and 5.

The Struggle to Create a Common Market:

1. As a result of pressures from domestic special interest groups, the process of transforming the members of the EU into a common market was a slow one. Even through the 1980s, firms doing business within the area had to comply with 12 different sets of national laws and regulations. The text provides several examples of the regulations followed by different members of the EU.
2. Initially, the EU relied on a process of **harmonization** (whereby the EC encouraged members to voluntarily adopt common "harmonized" regulations) to eliminate conflicting regulations. However, because the process moved so slowly (see the text for some examples), one of the EC's governing bodies, the European Commission, issued the White Paper on Completing the Internal Market. The White Paper called for accelerated progress on ending all trade barriers and restrictions on the movement of the factors of production.

3. Countries that accepted the White Paper signed the Single European Act and adopted its goal of completing the transformation to a common market by the end of 1992. The goal is known as **EC '92**. Substantial progress toward meeting the goal in the areas of physical, technical, and fiscal barriers has been made.

From Common Market to Economic Union

1. Many Europeans have argued for further integration, suggesting that the EU become an economic union. To that end, the **Treaty on European Union** (also known as the **Maastricht Treaty**) was reached in 1991. The treaty came into force in 1993.
2. The Maastricht Treaty rests on three “pillars” designed to further the economic and political integration of Europe. First is the agreement to create a common foreign and defense policy among member states. Second is an agreement to cooperate on police, judicial, and public safety matters. Third are new provisions to create an economic and monetary union among member states to augment the basic European Community agreement.
3. The Maastricht Treaty also grants citizens the right to live, work, vote, and run for election anywhere within the EU, and strengthens the power of the EU’s legislative body, the European Parliament, in budgetary, trade, cultural, and health matters. In addition, a **cohesion fund** was created to funnel economic development aid to countries with a GDP less than 90% of the EC average. Finally, the name change mentioned earlier occurred as the EC became the EU.
4. The most important and controversial aspect of the Maastricht Treaty was the creation of economic and **monetary union (EMU)** among members. The EMU created a single currency, called the euro, for the EU, and a single EU central bank. Denmark, Sweden, and the U.K. chose not to become charter members of the single currency bloc. The euro came into being on January 1, 1999 when the 11 charter participants irrevocably fixed the value of their national currencies to the euro.
5. During a three-year transition period, the euro existed only as a bookkeeping currency. Actual euro coins and currency were put into circulation at the beginning of 2002.
6. The ultimate goal of the EU, the creation of a single EU currency, implies that countries lose their ability to control their own domestic monetary supplies and economic destinies, and thus the goal has not been reached without controversy.
7. In order to participate in the EMU, member countries met certain convergence criteria relating to inflation rates, interest rates, currency values, government budget deficits, and government debt.
8. The **Treaty for Europe** (also known as the Treaty of Amsterdam), signed in 1997, allowed for a strong commitment to attack the EU’s high levels of unemployment, a strengthening of the role of the EU’s Parliament, and the establishment of a two-track system.
9. The **Treaty of Nice**, which became effective in February of 2003, reduced the number of areas in which unanimity was required in order for new policies to be approved. The following box addresses the issue further.

Three Majorities Are Better than One:

The Treaty of Nice requires that a qualified majority can be obtained only if three conditions (the so-called “triple majority”) are met: (1) the decision receives a specified percentage of the votes cast by Council members. The specified percentage will range between 71 and 74 percent (depending on the number of new members admitted to the EU); (2) a majority of the member states approve the decision; and (3) the decision is approved by members who represent at least 62% of the EU’s population.

1. **Future EU Challenges:** Other conflicts continue to be waged within the EU. For example, state aid to industry has been of particular concern to members. While the EU prohibits national governments from making subsidies that result in a distortion of competition, many governments still assist domestic companies that are in danger of bankruptcy.
2. Another controversy surrounds the question of whether and when the EU should expand its membership. At the heart of the controversy is the “**wider vs. deeper**” question. Supporters of the wider side suggest that the EU should rapidly expand its membership, even if it makes integration more difficult, while proponents of the deeper side argue that slow expansion is more appropriate.

REGIONAL AND ECONOMIC INTEGRATION

The Euro

Prior to the implementation of the Euro (the single European currency), member countries moved to converge their economies by

- Reducing inflation so that each country's inflation would be no more than 1.5 percentage points above the average of the three lowest inflation rates in Europe
- Reducing long-term interest rates so that each country's rate would be no more than two percentage points above the average of the three lowest.
- Reducing the government's budget deficit to no more than 3.5% of GDP
- Reducing the stock of public debt so that it would not exceed 60% of GDP.

Eleven countries adopted the Euro as of January 1999. The Euro will show up as an actual bank note (replacing individual currencies) in 2002. It is already widely used for a variety of no cash transactions.

Implications of the EU:

Although Europe is moving closer together through the Euro and the Single Market program, it is still not as homogenous as the U.S. market. Differences in languages, cultures, and governments still splinter Europe, and the eventual addition of new countries will create even more divisions in the market. Companies need to develop a pan-European strategy without sacrificing different national strategies.

NAFTA:

Trade negotiators also made an effort to prevent the establishment of screwdriver plants (factories in which very little transformation of the product is undertaken) in Mexico as a means of evading U.S. and Canadian tariffs by developing detailed rules of origin defining whether a good should qualify for preferential tariff treatment or not. The text provides an example of how such a situation might occur in the auto industry.

Impact of NAFTA on Trade, Investment, and Jobs:

Mexico's trade with the United States and Canada has grown since NAFTA. The Mexican peso crisis of 1994 temporarily slowed U.S. exports to Mexico. Mexico appears to be receiving more FDI from Europe as a result of NAFTA. As far as employment goes, it is virtually impossible to determine the employment impact of NAFTA because of the difficulty of trying to separate NAFTA from other factors.

Implications of NAFTA:

The integration of the U.S., Canadian and Mexican economies creates challenges and opportunities for MNEs. They can now rationalize their production throughout North America, and have free access to the North American market. However, they must adhere to strictly enforced local content laws. Mexico has become a more attractive investment option, both in terms of the duty-free access that Mexican-produced goods enjoy in the United States and in terms of the Mexican market as a consumption force in its own right.

ANCOM, the Andean Common Market, is the second most important regional group in South America. The **Andean Pact** was established in 1969 to promote free trade among Bolivia, Chile, Colombia, Ecuador, and Peru. The objective of the agreement was to make these small nations competitive with the continent's larger countries. Membership has changed over the years (Venezuela joined in 1973 and Chile dropped out in 1976), and at least for the first twenty years, the agreement was not successful.

The **Mercosur Accord** is an agreement between Argentina, Brazil, Paraguay, and Uruguay to cut internal tariffs and establish common external tariffs. The agreement is expected to revitalize the stagnating economies of Brazil and Argentina by stimulating new flows of FDI.

Response to Mercosur by businesses has been mixed. Some have quickly taken positions that allow them to capitalize on the opportunities created by the accord, while others fear an influx of cheaply made products will make it more difficult to compete. See Chapter 2's closing case for an update on Argentina.

Trade Agreements in the Asia-Pacific Region/Other regional agreements:

The Australia-New Zealand Agreement: The **Australia-New Zealand Closer Economic Relations Trade Agreement (known as CER)**, took effect in 1983. Its goal is to expand trade and straighten links in a diverse set of areas including investment, marketing, tourism, and transport. Most analysts agree that it has been highly successful. The Association of South East **Asian Nations (ASEAN)** was founded in 1967 by Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand to promote regional political and economic cooperation. The ASEAN Free Trade Area was established to promote intra-ASEAN trade.

Other Free Trade Agreements in the Americas: Other free trade agreements are currently being negotiated. Mexico in particular has been active in that respect, negotiating an agreement with Chile, an agreement with Venezuela and Colombia, and an agreement with five of its Central American neighbors.

REGIONAL AND ECONOMIC INTEGRATION**Learning objectives:**

1. Describe how demand and supply determine the price of foreign exchange.
2. Discuss the role of international banks in the foreign-exchange market.
3. Assess the different ways that firms can use the spot and forward markets to settle international transactions.
4. Summarize the role of arbitrage in the foreign-exchange market.
5. Discuss the important aspects of the international capital market.

IMPORTANT TERMS:

1. **Foreign exchange** is a commodity that consists of currencies issued by countries other than one's own. The **exchange rate** is the price of one currency in terms of another, at the equilibrium price of the foreign currency.
2. A **direct** quote is the price of the foreign currency in terms of the home currency, while an **indirect** quote is the price of the home currency in terms of the foreign currency.

Introduction:

1. Traditionally, different countries have different currencies (although the appearance of the EU and the euro have dramatically decreased the number of international currencies that most people will use). If you have examples of different currencies, these can be shown or passed around. Students are particularly intrigued by the pictures of foreign rulers on foreign currency, many of whom they have never heard of.
2. Tourists clearly need to change money when they travel between countries, although in some border towns merchants may accept currency from both countries.
3. Exchange rates determine the value of one currency in terms of another. It can be illustrative at this point to show some exchange rates by writing them down or using Table 9.1. Actually going through several currency conversions provides a basis for many of the following discussions. When I teach this chapter, I imagine the class strolling down the Via Veneto (Rome) and coming upon a display window with a Lamborghini listed at 1 million lira. Is this expensive? Students quickly convert lira into dollars to get the answer. (No! It's about \$454.10 when 1 lira equals 0.0004541 dollars, which is the conversion rate as I write this.)
4. While dealing in multiple currencies is a requirement of doing business internationally, it also creates risks and significantly alters the attractiveness of different investments and deals over time. Firms can use the foreign exchange market to minimize the risk of adverse changes, but this can prevent them from benefiting from favorable changes.
5. Depending upon the student group, the need to go into many details will vary considerably. When teaching this topic to a group of international MBA students in Europe, it was unnecessary to cover the basics - they knew from everyday life as they converted the price of food into their own

currencies to assess value. However, a group of US students were surprised that a McDonald's they visited on a road trip to Canada for a hockey game didn't take US dollars.

6. One thing that may be helpful is to bring into class paper bills of \$100, 100 NOK, 100£, and 100 Pakistani rupees, and offer to buy a student's calculator. First you may start with the rupees, and try to convince him or her that you have a great deal. If you experience some reluctance, you might next offer the Norwegian Kroner. Depending upon the calculator, you might offer the 100£ but ask for \$70 back in change. Regardless you can usually cause a little confusion and get some people flustered, thinking that they might be passing up a really good deal and just don't know it.

The Functions of the Foreign Exchange Market:

1. The foreign exchange market serves two functions: converting currencies and reducing risk. There are four major reasons firms need to convert currencies.
2. First, the payments firms receive from exports, foreign investments, foreign profits, or licensing agreements may all be in a foreign currency. In order to use these funds in its home country, an international firm has to convert funds from foreign to domestic currencies.
3. Second, a firm may purchase supplies from firms in foreign countries, and pay these suppliers in their domestic currency.
4. Third, a firm may want to invest in a different country from that in which it currently holds under-used funds.
5. Fourth, a firm may want to speculate on exchange rate movements, and earn profits on the changes it expects. If it expects a foreign currency to appreciate relative to its domestic currency, it will convert its domestic funds into the foreign currency. Alternately stated, it expects its domestic currency to depreciate relative to the foreign currency. An example similar to the one in the book can help illustrate how money can be made (or lost) on exchange rate speculation. The management focus on George Soros shows how one fund has benefited from currency speculation.
6. Exchange rates change on a daily basis. The price at any given time is called the spot rate, and is the rate for currency exchanges at that particular time. One can obtain the current exchange rates from a newspaper or online (e.g., www.wsj.com). Comparing these with the rates listed in Table 9.1 can show which currencies have undergone the most significant changes since the time of publication.
7. The fact that exchange rates can change on a daily basis depending upon the relative supply and demand for different currencies increases the risks for firms entering into contracts where they must be paid or pay in a foreign currency at some time in the future.
8. Forward exchange rates allow a firm to lock in a future exchange rate for the time when it needs to convert currencies. Forward exchange occurs when two parties agree to exchange currency and execute a deal at some specific date in the future. The book presents an example of a laptop computer purchase where using the forward market helps assure the firm that it won't lose money on what it feels is a good deal. It can be good to point out that from a firm's perspective,

while it can set prices and agree to pay certain costs, and can reasonably plan to earn a profit; it has virtually no control over the exchange rate. When spot exchange rate changes entirely wipe out the profits on what appear to be profitable deals, the firm has no recourse.

9. Table 9.2 shows currency use on one side of a foreign exchange transaction. When a currency is worth less with the forward rate than it is with the spot rate, it is selling at **forward discount**. Likewise, when a currency is worth more in the future than it is on the spot market, it is said to be selling at a **forward premium**, and is hence expected to **appreciate**. These points can be illustrated with several of the currencies shown in Table 9.2.
10. A currency swap is the simultaneous purchase and sale of a given amount of currency at two different dates and values. Figure 9.1 shows an indication of the relative importance of the different types of currency exchanges.

INTRUMENTS:

1. Currencies can be traded in the **spot** market or in the **forward** market. Spot transactions are delivered in two business days, while forward transactions are delivered at the specified forward date of 30, 90, or 180 days. Most transactions in the forward market are swap transactions in which the trader simultaneously buys and sells the same currency with different delivery dates.
2. **Currency futures** are used to obtain foreign exchange; however, unlike forward contracts, they are designed with standard amounts for standard delivery dates. Currency can also be obtained through **currency options**. A **call** option allows the holder to purchase a specified quantity of foreign exchange at a specified price by a specified date, while a put option allows a holder to sell a specified quantity of foreign exchange at a specified price by a specified date. Options do not have to be exercised. Hedging is used by firms to reduce their foreign-exchange risk.
3. If the forward price and the spot price of a particular currency are different, then the currency is said to be selling at a **forward discount** (forward price is lower than the spot price) or **forward premium** (forward price is higher than the spot price.) **Spot and Forward Markets**
2. Currencies can be traded in the spot market or in the forward market. Spot transactions are delivered in two business days, while forward transactions are delivered at the specified forward date of 30, 90, or 180 days. Most transactions in the forward market are swap transactions in which the trader simultaneously buys and sells the same currency with different delivery dates.
3. **Currency futures** are used to obtain foreign exchange; however, unlike forward contracts, they are designed with standard amounts for standard delivery dates. Currency can also be obtained through **currency options**. A call option allows the holder to purchase a specified quantity of foreign exchange at a specified price by a specified date, while a put option allows a holder to sell a specified quantity of foreign exchange at a specified price by a specified date. Options do not have to be exercised. Hedging is used by firms to reduce their foreign-exchange risk.

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Options:

An option is the right but not the obligation to buy or sell a foreign currency within a certain time period or on a specific date. Options provide the company flexibility, because it can walk away from the option if the price is worse than the spot market on the date of the option. Forward contracts are cheaper than options, but the company cannot walk away from the contract.

Futures:

A foreign currency future resembles a forward contract in that it specifies an exchange rate sometime in advance of the actual exchange of currency. However, a future is traded on an exchange, not OTC. A forward contract is tailored to the amount and time frame that the company needs. Futures contracts have preset amounts and maturity dates.

Foreign Exchange Convertibility:

Fully convertible currencies are those that the government allows both residents and nonresidents to purchase in unlimited amounts. Hard currencies (e.g., U.S. dollar, Japanese yen) are currencies that are fully convertible. Currencies that are not fully convertible are often called soft currencies or weak currencies.

HOW COMPANIES USE FOREIGN EXCHANGE:

The most obvious reason why companies use the foreign exchange market is for import and export transactions. Sometimes companies speculate in the foreign exchange market for profit (though this is more commonly done by traders and investors). One type of profit-seeking activity is arbitrage (which is the purchase of foreign currency in one market for immediate resale in another market to profit from a price discrepancy). Interest arbitrage is the investing in debt instruments (e.g., bonds) trying to maximize profit by investing in the best interest/currency combination.

HOW COMPANIES USE FOREIGN EXCHANGE:

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THE FOREIGN EXCHANGE TRADING PROCESS:

When a company needs foreign exchange, it typically goes to its commercial bank for help. If it is a large enough bank, it may have its own foreign exchange traders that buy and sell foreign currency. If it is a smaller bank, it can order foreign currency through one of its larger correspondent banks.

Commercial and Investment Banks:

Large companies may use several banks for dealing in foreign exchange by selecting those that specialize in specific geographic areas, instruments, or currencies. Other factors determining which banks a company will select include price, quote speed, credit rating, liquidity, back office/settlement, strategic advice, trade recommendation, out-of-hours service/night desk, systems technology, innovation, and risk appraisal.

The Chicago Mercantile Exchange:

The Chicago Mercantile Exchange (CME) is a not-for-profit corporation owned by its 2,725 members who have bought seats on the exchange. Its product line consists of futures and options on futures within four categories: agricultural commodities, foreign currencies, interest rates, and stock indexes.

The Philadelphia Stock Exchange:

The Philadelphia Stock Exchange (PHLX) is the only exchange in the United States that trades foreign currency options (the CME trades options on futures contracts rather than spot contracts). PHLX allows for standardized and customized options.

Unit 10**INTERNATIONAL MARKETING****Learning Objectives:**

1. Examine the process used to conduct an international market assessment of goods and services.
2. Study the criteria that affect a multinational enterprise's (MNE's) decision to alter a good or service in order to adapt the offering to local market tastes.
3. Describe some of the ways in which multinational enterprises (MNEs) use advertising and personal selling techniques to promote their product in worldwide markets.
4. Review some of the major factors that influence international pricing and distribution strategies.

Lesson out lines:

International market assessment

Initial screening: basic need and potential

Second screening: financial and economic conditions

Third screening: political and legal forces

Fourth screening: sociocultural forces

Fifth screening: competitive environment

Final selection

Product strategies

Little or no modification

Moderate to high modification

Economics

Culture

Local laws

Product life cycle

Promotion

Nature of the product

Advertising

Personal selling

Pricing

Government controls

Market diversity

Currency fluctuations

Price escalation forces

Place

Introduction:

International marketing is the process of identifying the goods and services that customer's outside the home country want and then providing them at the right price and place. In the international marketplace

this process is similar to that carried out at home, but with some important modifications to adapt marketing efforts to the needs of the specific country or geographic location. These changes fall into five major areas: market assessment, product decisions, promotion strategies, pricing decisions, and place or distribution strategies.

INTERNATIONAL MARKETING

MARKET SIZE ANALYSIS:

Once companies decide to enter markets, they must then analyze data to determine their market potential in each country and their marketing mix to reach the potential.

Total Market Potential:

To determine potential demand, managers first estimate the possible sales of the category of products for all companies and then estimate its own company's market-share potential. In order to do so, they estimate per capita consumption and move it along a trend line as per capita GNP increases.

Gap Analysis:

Once a company is operating in a country and estimates that country's market potential, it must calculate how well it is doing there. Gap analysis is a method for estimating a company's potential sales by identifying market segments it is not servicing adequately.

International market assessment:

1. International marketing strategy starts with international market assessment, an evaluation of the goods and services that the multinational enterprise (MNE) can sell in the global marketplace. This assessment typically involves a series of analyses aimed at pinpointing specific offerings and geographic targets. The first step in this process is called the initial screening.
2. Initial screening is the process of determining the basic need potential of the multinational enterprise's (MNE's) goods and services in foreign markets. This screening answers the question: who might be interested in buying our output? One way in which initial screening is carried out is by examining the current import policies of other countries and identifying those goods and services that are now being purchased from abroad. A second way is by determining local production. A third is by examining the demographic changes that are taking place in the country that will create new, emerging markets.
3. Secondary screening is used to reduce the list of market prospects by eliminating those that fail to meet financial and economic considerations. Financial considerations include inflation rates, interest rates, expected returns on investment, the buying habits of customers, and the availability of credit. Economic considerations relate to a variety of market demand influences, including market indicators.
4. Market indicators are used for measuring the relative market strengths of various geographic areas. These indicators focus on three important areas: market size, market intensity, and market growth. Market size is the relative size of each market as a percentage of the total world market. Market intensity is the "richness" of the market, or the degree of purchasing power in one country as compared to others. Market growth is the annual increase in sales. Quite often, these data are analyzed using quantitative techniques such as trend analysis, estimation by analogy, regression analysis, and/or cluster analysis.

5. The third level of screening involves looking at political and legal forces. One of the primary considerations is an entry barrier in the form of import restrictions or limits on the local ownership of business operations.
6. The fourth level typically involves the consideration of sociocultural forces such as language, work habits, customs, religion, and values. Multinational enterprises (MNEs) examine these sociocultural differences in determining where to locate operations.
7. The fifth level of screening is typically focused on competitive forces. In some cases multinational enterprises (MNEs) decide to enter a competitive market because they believe the potential benefits far outweigh the drawbacks. By going head-to-head with the competition, the company can force itself to become more efficient and effective and thus improve its own competitiveness.
8. Before making a final selection, multinational enterprises (MNEs) usually enhance their information by visiting on-site locations and talking to trade representatives or local officials. Such field trips are very common and can do a great deal to supplement currently available information.

INTERNATIONAL MARKETING

Product strategies:

1. Product strategies depend on the specific goods and customers. Some products can be manufactured and sold successfully both in the home market and abroad by using the same strategies. Other products must be modified or adapted and sold according to a specially designed strategy.
2. Industrial goods and technical services are good examples of products that need little or no modification. Other products, because of economics, culture, local laws, level of technology, or the product's life cycle, require a moderate to high level of modification.
3. There are many examples of how economic considerations affect the decision to modify a product. As a very simple example, in the United States, packets of chewing gum often contain 10 to 20 sticks, but in many other countries the weaker purchasing power of the customers necessitates packaging the gum with only five sticks. Economics is also important when the cost of a product is either too high or too low to make it attractive in another country.
4. In some cases a product must be adapted to the different ways people are accustomed to doing things. For example, the French prefer washing machines that load from the top, while the British like front-loading units. In fast-food franchises such as McDonald's, parts of the menu are similar throughout the world, but some items are designed to cater specifically to local tastes. Culture also influences purchasing decisions made on the basis of style or aesthetics. Convenience and comfort are other culturally driven factors that help explain the need for product modification. Others include color and language.
5. Local laws can require the modification of products to meet environmental and safety requirements. For example, US emission-control laws have required Japanese and European car importers to make significant model changes before their vehicles can be sold in the United States.
6. Another reason for modifying a product is to cope with the limited product life cycle of the good. Ford Motor, for example, was extremely profitable in Europe during the 1980s, but these earnings disappeared by the early 1990s because it did not develop new, competitive products.

PROMOTION:

Promotion is the presentation of messages intended to help sell a product or service. The types and direction of messages and the method of presentation may be extremely diverse, depending on the company, product, and country of operation.

The Push-Pull Mix:

Promotion may be characterized as push, which uses direct selling techniques, or pull, which relies on mass media. To what degree a company should rely on push or pull depends in part on:

1. Type of distribution system
2. Cost and availability of media to reach target markets

3. Consumer attitudes toward sources of information
4. Price of the product compared to incomes

Standardization of Advertising Programs:

The savings from using the same advertising programs as much as possible, such as on a global basis or among countries with shared consumer attributes, are not as great as those from product standardization, but can be significant.

- **Translation:** On the surface, translating a message would seem to be easy. However, some messages, particularly plays on words, simply cannot be translated.
 - **Legality:** What is legal advertising in one country may be illegal elsewhere. The differences result mainly from varying national views on consumer protection, competitive protection, promotion of civil rights, standards of morality, and nationalism.
 - **Message needs:** An advertising theme may not be appropriate everywhere because of national differences.
1. Promotion is the process of stimulating demand for a company's goods and services. In promoting a product, a variety of approaches can be used, including identical product and identical message, identical product but different message, modified product but same message, and modified product and different message.
 2. Advertising is a no personal form of promotion in which a firm attempts to persuade consumers to a particular point of view. In many cases, multinational enterprises (MNEs) use the same advertising message worldwide. However, there are times when the advertising must be adapted to the local market. Two of the most common reasons include: (a) the way in which the product is used is different from that in the home country; and (b) the advertising message does not make sense if translated directly.
 3. MNEs use a number of media to carry their advertising messages. The three most popular are television, radio, and newspapers. In particular, the use of television advertising has been increasing in Europe, while in other regions, such as South America and the Middle East, newspapers remain the major media for promotion efforts. However, there are restrictions regarding what can be presented. Examples include: (a) some countries prohibit comparative advertising, in which companies compare their products against those of the competition; (b) some countries do not allow certain products to be advertised because they want to discourage their use (alcoholic beverages and cigarettes, for example) or because they want to protect national industries from multinational enterprise (MNE) competition; and (c) some countries, such as most Islamic countries, censor the use of any messages that are regarded as erotic.
 4. Personal selling is a direct form of promotion used to persuade customers to a particular point of view. Some goods, such as industrial products or goods that require explanation or description, rely heavily on personal selling. Personal selling is also widely used in marketing products such as pharmaceuticals and sophisticated electronic equipment.

5. Because many international markets are so large, some multinational enterprises (MNEs) have also turned to telemarketing. Multinational enterprises (MNEs) have also focused their attention on recruiting salespeople on an international basis.

PRICING:

Within the marketing mix, companies place much importance on price. Pricing is more complex internationally because of the following factors:

Governmental Intervention:

Every country has laws that affect the prices of goods at the consumer level. A governmental price control may set either maximum or minimum prices. The WTO permits countries to establish restrictions against any import that comes in at a price below that charged to consumers in the exporting country. A company may also charge different prices in different countries because of competitive and demand factors.

Greater Market Diversity:

Country-to-country variations create many ways of segmenting the market for a product. For example, companies can sell few tuna eyeballs in the United States at any price, but when exported to Japan they are considered delicacies. When a firm has a near monopoly in a foreign market, it can adopt any of the following pricing strategies:

- Skimming—charging a high price for a new product by aiming it first at consumers willing to pay the price, then progressively lowering the price.
- Penetration—introducing a product at a low price to induce a maximum number of consumers to try it.
- Cost-plus—pricing at a desired margin over cost.

Price Escalation in Exporting:

If standard markups occur within international distribution channels, or there are other added expenses within the system, the price to the consumer will escalate. Common reasons for price escalation in export sales are the distance to the market and tariffs.

Currency Value and Price Changes:

Pricing in highly volatile currencies can be extremely troublesome—especially under conditions of high inflation. This may result in the need for frequent price readjustments, and the firm may find that the funds it receives in the foreign currency, when converted, buy less of the company's own currency than expected.

Fixed versus Variable Pricing:

The extent to which manufacturers can or must set prices at the retail level varies substantially by country. In many cultures, retail prices are simply the starting point in a bargaining process. Local laws and customs often limit companies' abilities to price as they choose.

Retailers' Strength with Suppliers:

Dominant retailers with clout can get suppliers to offer them low prices and then compete on the basis of being the lowest cost retailer. This clout in the domestic market (e.g., Wal-Mart, Carrefour) may not exist for the retailer in foreign markets.

1. Every nation has government regulations that influence pricing practices. In some countries, for example, there are minimum and maximum prices that can be charged to customers. Governments also prohibit dumping or the selling of imported goods at a price below cost or below that of the home country.
2. Consumer tastes and demands vary widely in the international marketplace, resulting in multinational enterprises (MNEs) having to price some of their products differently. For example, companies have found that they can charge more for goods sold overseas because of the demand. A second factor influencing market diversity is the perceived quality of the product. Another factor is the tax laws and attitudes about carrying debt.
3. When selling products overseas, multinational enterprises (MNEs) often end up assuming the risks associated with currency fluctuations. This risk is particularly important when multinationals have a return on investment target, because this objective can become unattainable if the local currency is devalued. Price escalation forces (for example, changes in input prices) that drive up the cost of imported goods cause a similar problem.

Place:

1. Distribution is the course that goods take between production and the final consumer. This course often differs on a country-by-country basis, and multinational enterprises (MNEs) spend much time examining the different systems that are in place, the criteria to use in choosing distributors and channels, and how the distribution segmentation will be employed.
2. It is often difficult to standardize the distribution system and use the same approach in every country, because there are many individual differences to be considered. Consumer spending habits can negate attempts to standardize distribution. The location where consumers are used to buying will also influence distribution.
3. There are a number of criteria that multinational enterprises (MNEs) use in creating the most efficient distribution system. One is to get the best possible distributors to carry their products. Depending on the nature of the market and the competition, a multinational may give exclusive geographic distribution to one local seller or may arrange to have a number of sellers jointly selling the product.

Strategic management and marketing strategy:

1. Marketing strategies play a key role in helping multinational enterprises (MNEs) to formulate an overall plan of action. These include ongoing market assessment, new product development, and the use of effective pricing.
2. One of the major areas multinational enterprises (MNEs) are continuing to pay attention to is data collection and analysis for the purpose of developing and updating market assessments. In some cases, this causes multinationals to change their market approach, while in other cases it supports the maintenance of a current strategy.

3. Another marketing area that is a critical part of the management plan of many multinational enterprises (MNEs) is new product development. The introduction of new products is helping these firms maintain market share and is positioning them for future growth.
4. Some multinational enterprises (MNEs) use high pricing with high quality to skim the cream off the market.

BRANDING:

A brand is an identifying mark for products or services. An MNE must make four major branding decisions:

- Brand versus no brand
- Manufacturer's brand versus private brand
- One brand versus multiple brands
- Worldwide brand versus local brands

Language Factors:

Brand names may carry a different association in another language. Pronunciation may also be a problem.

INTERNATIONAL MARKETING EXPORT & IMPORT**Learning Objectives:**

- To Look at the international marketing strategy
- To identify the key elements of export and import strategies
- To compare direct and indirect selling of exports
- To discuss the role of several types of trading companies in exporting
- To show how freight forwarders help exporters with the movement of goods
- To identify the methods of receiving payment for exports and the financing of receivables
- To discuss the role of counter trade in business

PRODUCT POLICY:

This section highlights the international application of common product policies.

Production Orientation:

With a production orientation, companies focus primarily on production—either efficiency or high quality—with little emphasis on marketing. Such an approach is used internationally in commodity sales, passive exports (surpluses of domestic production), and foreign market niches that resemble the market at which the good was originally aimed.

Sales Orientation:

Internationally, sales orientation means a company tries to sell abroad what it can sell domestically on the assumption that consumers are sufficiently similar globally. This orientation differs from the production orientation because of its active rather than passive approach to promoting sales. A sales orientation leads the manager to ask questions like: Where can the company sell more of product X?

Customer Orientation:

A customer orientation asks: What can the company sell in country X?

Strategic Marketing Orientation:

Most companies committed to continual rather than sporadic foreign sales adopt a strategy that combines production, sales, and consumer orientations. Such companies are adopting a strategic marketing orientation.

Societal Marketing Orientation:

Companies with societal marketing orientations seriously consider potential environmental, health, social, and work-related issues associated with selling or making products abroad.

Reasons for Product Alteration:

- **Legal reasons:** Explicit legal product requirements vary widely country by country. Legal requirements may be intended to protect the consumer, protect the environment, or may exist for some other reason.
- **Cultural reasons:** Cultural differences may require that products be altered to a form more pleasing to the culture. Color preferences, for example, often vary across countries.
- **Economic reasons:** If foreigners lack sufficient income, they may not be able to buy the product as the MNE sells it domestically, and price-reducing alterations may be required.

Alteration Costs:

Some product alterations are cheap to make yet have an important influence on demand. One cost-saving strategy a company can use to compromise between uniformity and diversity is to standardize a great deal while altering some end characteristics.

Extent and Mix of Product Line:

Most companies produce multiple products, not all of which would be successful in the same foreign market. Usually the company starts in a foreign market with fewer products and increases the number over time.

Product Life-Cycle Considerations:

There may be differences among countries in either the shape or length of a product's life cycle. A product facing declining sales in one country may have growing or sustained sales in another. International marketing decisions should consider the differences in life-cycle stages across countries.

EXPORT STRATEGY:

In general, small companies will use low-risk international business entry modes such as exporting. Exporting requires a lower level of investment than other modes (such as FDI), but it also offers a lower risk/return on sales. Exporting allows significant management operational control, but does not provide much marketing control, as the exporter is far from the consumer and must deal with independent distributors abroad.

Characteristics of Exporters:

Although the probability of being an exporter increases with company size (defined by revenues), the export intensity (% of total revenues coming from exports) is not associated with company size. That is, as firms grow, exporting as a percentage of revenues does not necessarily grow at the same pace.

Why Companies Export:

Companies export primarily to increase sales revenue—whether they are service firms or manufacturing firms.

Stages of Export Development:

Export development has three broad phases: pre-engagement, initial exporting, and advanced exporting. Companies seem to be exporting sooner in their life cycle in part because Internet surfers from all over the world can have instant access to the company's product line directly.

Potential Pitfalls of Exporting:

- Failure to obtain qualified export counseling and develops a plan.
- Insufficient commitment by top management.
- Poor choices for overseas agents or distributors.
- Chasing orders instead of orderly growth plans.
- Neglecting exports when domestic market booms.
- Failure to treat international distributors as equals to domestic distributors.
- Unwillingness to modify product to comply with other countries' requirements.
- Failure to print service, sales, and warranty messages in local languages.
- Failure to use an intermediary when a company does not have the personnel to handle export functions.

Designing an Export Strategy:

To establish a successful export strategy, management must:

- Assess the company's export potential by examining its opportunities and resources.
- Obtain expert counseling on exporting.
- Select a market or markets.
- Formulate and implement an export strategy.

IMPORT STRATEGY:

There are two basic types of imports: Intra-company imports (these provide intermediate goods and services to companies that are part of the firm's global supply chain) and imports that provide industrial and consumer goods and services to individuals and companies that are not related to the exporter. There are three basic types of importers:

- Those that are looking for any product around the world that they can import and sell domestically.
- Those that are looking at foreign sourcing to get their products at the cheapest price.
- Those that use foreign sourcing as part of their global supply chain.

The Role of Customs Agencies:

When importing goods into any country, a company must be totally familiar with the customs operations of the importing country. A broker or other import consultant can help an importer minimize costs and delays.

Documentation:

The importer must possess and file specific documents in order to take possession of imported goods when they arrive at their destination country. The specific documents customs require vary by country, but include an entry manifest, commercial invoice, and packing list.

THIRD-PARTY INTERMEDIARIES:

Third-party intermediaries are used by both exporters and importers. They are companies unrelated to the importer or exporter whose purpose is to facilitate trade.

Direct Selling:

Direct selling is when an exporter sells through sales representatives, to distributors, to foreign retailers, or to final end users.

Direct Exporting through the Internet and Electronic Commerce:

Electronic commerce is an important way for companies to export their products to end users. It is especially important for small and medium-sized enterprises (SMEs). Internet marketing is a direct form of marketing that is exploding in importance.

Indirect Selling:

In indirect selling, the exporter sells goods directly through an independent domestic intermediary in the exporter's home country that exports the products to foreign markets. The major types of indirect intermediaries are the export management company (EMC), the export trading company (ETC), export agents, merchants, remarket, and piggyback marketers.

Export Management Companies:

The EMC primarily obtains orders for its clients' products through the selection of appropriate markets, distribution channels, and promotion campaigns. The EMC may also take care of export documents, arrange transportation, set up patent and trademark protection in foreign countries, and assist in establishing alternative forms of doing business, such as licensing or joint ventures.

Export Trading Companies:

ETCs resemble EMCs, and the terms are often used interchangeably. ETCs are like independent distributors that match up buyers and sellers. Rather than representing a manufacturer, an ETC looks for as many manufacturers as it can find to supply overseas customers.

Non-U.S. Trading Companies:

Japan has the largest trading companies in the world. The sogo sosha (the Japanese equivalent of a trading company) can trace its roots back to the late nineteenth century. The Japanese trading companies are big in commodities.

Piggyback Exports:

Sometimes an exporter can use another exporter as an intermediary. For example, a company may agree to supply products to a foreign distributor even though it does not produce the entire range of products. Then it might look for other manufacturers to fill the gaps in the product line. In this way, the second manufacturer becomes an exporter indirectly by using the first exporter's distribution channels.

Foreign Freight Forwarders:

To assist in the transport of goods from one country to another, companies usually employ the services of a freight forwarder. A freight forwarder is an agent for the exporter in moving cargo to an overseas destination. Even export management companies and other types of trading companies often use the specialized services of foreign freight forwarders.

Documentation:

Freight forwarders also can help exporters fill out exporting documents. Of the many documents required, some of the most important are: pro forma invoice, commercial invoice, bill of lading, consular invoice, certificate of origin, shipper's export declaration, and export packing list.

EXPORT FINANCING:

From the exporter's point of view, there are four major issues that relate to the financial aspects of exporting: the price of the product, the methods of payment, the financing of receivables, and insurance.

Product Price:

Internationally, pricing must take into account foreign exchange rate fluctuations, transportation costs, and duties, as well as antidumping laws.

Methods of Payment:

Basic payment methods, from most secure to less secure are:

- Cash in advance
- Letter of credit
- Draft or bill of exchange
- Open account
- Other payment mechanisms, such as consignment or counter trade

Financing Receivables:

Because exporting is risky, banks are often unwilling to provide funding for it. However, exporters can get access to funds through factoring (discounting of a foreign account receivable) and forfeiting (when a forfeiter buys from an exporter the debt due from its customer). In addition, exporters can apply for guarantees from government agencies (such as the State Bank) in order to get banks to loan them money while waiting for receivables.

Insurance:

Insurance is used to cover the transportation of goods, as well as to cover political, commercial, and foreign exchange risk. Some private sector insurers cover these types of risks (for established exporters with a proven track record), but government agencies tend to be the most important insurers for political risk.

EXPORT, IMPORT, FDI INTERNATIONAL BUSINESS & PAKISTAN**Learning Objectives:**

- Export & Import
- Strategies for import and export
- Status of Pakistan in Exports and Imports
- FDI and Pakistan
- International Business and Pakistan

Export Assistance, Pakistan:

1. Export Promotion Bureau
2. State bank of Pakistan as export refinance.
3. Chambers of Commerce and industries as facilitators.
4. Government as announcing special incentive to exporters like rebates etc.

Export Assistance, International:

1. Exporters in the US can draw upon two types of government-backed assistance to help finance their exports; the Export-Import bank and export credit insurance provided by the FCIA.
2. The Export-Import Bank is an independent agency of the US government whose mission is to provide aid in financing and facilitate exports and imports and the exchange of commodities between the US and other countries.
3. In the US, the Foreign Credit Insurance Association (FCIA) provides export credit insurance. The FCIA provides insurance policies protecting US exporters against the risk of nonpayment by foreign debtors as a result of commercial and political risks.

Counter trade:

1. Counter trade is a term that covers a whole range of barter like agreements. It is primarily used when the firm is exporting to countries whose currency is not freely convertible, and who may lack the foreign exchange reserves required to purchase the imports.
2. By some estimates, counter trade accounted for 20% of world trade by volume in 1998
3. There are five distinct types of counter trade - barter, counter purchase, offset, switch trading, and buy back.
4. Barter is the direct exchange of goods and services, or both, between two parties without a cash transaction. Although in theory barter is the simplest arrangement, in practice it is not that common.
5. Counter purchase is a reciprocal buying agreement. It occurs when a firm agrees to purchase a certain amount of materials back from a country to which a sale is made.
6. Offset is similar to counter purchase because the exporter is required to purchase goods and services with an agreed percentage of the proceeds from the original sale. The difference is that the exporter can fulfill this obligation with any firm in the country to which the sale is being made.

7. The term "switch trading" refers to the use of a specialized third-party trading house in a counter trade arrangement. When a firm enters into a counter purchase or offset agreement with a country it often ends up with what are called "counter purchase credits". These should be used to purchase goods from that country. Switch trading occurs when a third party trading house buys the firm's counter purchase credits and sells them to another firm that can make better use of them.
8. A buyback occurs when a firm builds a plant in a country, or supplies technology, equipment, training, or other services to the country, and agrees to take a certain percentage of the plant's output as partial payment for the contract.
9. The main attraction of counter trade is that it gives a firm a way to finance an export deal when other means are not available. A firm that insists on being paid in hard currency may be at a competitive disadvantage vis-à-vis one that is willing to engage in counter trade.
10. The main disadvantage of counter trade is that it may involve the exchange of unusable or poor quality goods that cannot be disposed of profitably.
11. As an option, counter trade is most attractive to large, diverse, multinational enterprises that can use their worldwide network of contacts to profitably dispose of goods acquired in a counter trade agreement. It is less attractive to small and medium sized exporters who lack a similar network.

Pattern of FDI Inflows in Pakistan:

Till the end of December 2003, Pakistan had attracted a very meager amount of FDI, ie, just US \$ 227 million. By the end of December 2004 the total FDI inflows to Pakistan amounted to US \$ 445 million, which is higher by 96 per cent over the figure of 2003. This is an enormous rise within a year and this means that now investors are looking at Pakistan as a destination for their FDI. This also indicates that the prospects of large-scale investment are greater now than in the last decade of 1990s and prior to that too.

Although it was less than the half a billion dollars expected, it was 61 per cent more than the \$277 million investment made in the same period last year. The indications for the future are far more attractive, running into billions of dollars.

The inflow of FDI has registered a 52 per cent increase during the first seven months (July-January) of the current fiscal year over the same period of the last year. Official figures released by the Board of Investment (BoI) here on Tuesday showed that the inflow of FDI during the period under review reached \$515 million against \$339.5 million during the same period of last year. The board expected that with the inflow of funds from M/s Kanooz Al Watan of Saudi Arabia for the purchase of KESC, the FDI inflows during the fiscal year would not only exceed \$1 billion mark, but would also be the highest in Pakistan's history.

The largest investment so far announced is that of the German company Daimler Chrysler along with the Coastal Group of the UAE. They propose to invest \$3 billion through two companies - one for production of hydropower on which \$2 billion will be spent and the other billion dollars

on the manufacture of trucks and then cars.

Sectoral Pattern: The major sectors, which attracted FDI during the period under review, were oil and gas with an amount of US \$123.2 million. Communications accounted for US \$72.1 million. The power sector has an FDI worth US \$43.4 million. Chemicals have a small volume of FDI US \$30 million. Trade segment has FDI worth US \$27.5 million. Financial business accounted for US \$60.1 million. Others sectors have marginal value worth US \$158.7 million.

Major Investors: Among the leading investors in Pakistan, the United States is occupying the lead during this period by investing US \$129.2 million. The second biggest investing nation in Pakistan after the US is the United Kingdom with an amount of FDI US \$95 million investment. Germany and Saudi Arabia are the emerging countries on the Pakistan's map of FDI. There are other investing countries. But their FDI is of marginal nature.

The Board of Investment is a prime agency created by the government of Pakistan for facilitating local and foreign investors to establish business in the country. According to the BoI, there are bright prospects for FDI inflows to Pakistan. This is because the government of Pakistani has successfully created both macro and micro business environment in the country. The country has offered foreign and domestic investors a string of high profit businesses as part of its new industrial policy, which is advocating for totally opening up the economy. Prospective investors have been allowed certain essential segments required for attracting FDI inflows namely a 100 per cent ownership and equity, full repatriation of total dividends, profits, gains and remunerations, wages and fees. These concessions would go a long way in making Pakistan a favorable destination for FDI.

Conclusion: From the foregoing pages it is clear that Pakistan has not been a favorable destination for FDI inflows. But the present government is committed to making Pakistan a favorable destination for FDI inflows. Accordingly, the government has taken a lot of measures in this direction. Recently the government said the trade deficit would be bridged by inviting more FDI inflows to Pakistan. The government of Pakistan has made concerted efforts on both the counts, i.e., micro and macro environment, sine qua non for becoming favorable destination. It is hoped that in years to come Pakistan would get a reasonable volume and value of FDI, which is the necessity of the day.

Foreign investment jumps in September-2006:

Foreign private investment in Pakistan's stock market has suddenly jumped in September. Almost all the investments came from the United States and the United Kingdom.

Official figures released by the State Bank showed that up to September 22 this year, an investment to the tune of \$42.096 million flew into Pakistani stocks. It was much higher than the portfolio investments made in July and August that totaled \$31.9 million.

The figures showed that only investors from the US and the UK were active while the usually active Singapore, the UAE, Saudi Arabia and some European countries remained on sidelines. The US invested \$26.730 million and the UK \$16.371m in September.

Experts said most of the investments went in the oil sector, while telecommunications and cement also attracted some investments. Analysts said if the pace of portfolio investment continues for the whole year, it might cross the last year investment. During 2005-06, a total of \$351.5 million was recorded as portfolio investment.

The inflow of foreign direct investment (FDI) also went up significantly during the first two months of the current fiscal year. During July-August 2006-07, FDI reached \$375.4 million against \$230.8 million during the corresponding period last year, showing a rise of 63 per cent.

PAKISTAN & EXPORTS

Cotton Fabrics:-

- Export of Cotton Fabrics came up to \$ 1.863 Billion from \$ 1.711 Billion in the year 2004-05 as compared with 2003-04. showing an increase of 9 % in A.U.P. However a decrease of 0.4% is recorded in Quantity which came down to 2399.5 Million Sqm. From 2409.4 million Sqm.
- Major buyers of the product were USA, Turkey, Hong Kong, U.A.E. and Italy

Garments:

- Export of Garments increased by 11%, contributed 18.9% in the total Pak export during 2004-05.
- Hosiery went up to \$ 1635 Million in the period under review 2004-05 as compared \$1459 Million in last year. Upward trend was witnessed in exports to USA,
- Leather and Leather Products
- Showing an increase of 26%, exports of Leather and Leather Products went up to \$ 938.5 Million from \$ 744.1 Million.
- Leather Gloves; registered an increase of 132.4% from \$ 70.7 million of the previous year to \$164.3 million.
- Surgical Instruments; The exports, which were \$ 132.56 Million in 2003-04 came up to \$ 182.88 Million in 2004-05, showing an increase of 38%.
- Sports Goods; from \$ 325 Million in 2003-04 the exports came down to \$ 307 Million in 2004-05, showing a decrease of 5.4%.

EXPORTS:

- 1994-95 \$8.1bn
- 1995-96 \$8.7bn
- 1996-97 \$8.3bn
- 1997-98 \$8.6bn
- 1998-99 \$7.8bn

Pakistan and Exports of other countries:

- COUNTRIES CAGR
- JAPAN 0.76%

- MALAYSIA -1.75%
- KOREA 0.88%
- PHILIPPINES 6.25%
- INDIA 6.85%
- CHINA 9.84%
- USA 0.88%
- UK 0.77%
- SINGAPORE -0.65%
- PAKISTAN 5%